ACCESS TO CREDIT INITIATIVE IN UKRAINE & MOLDOVA

FINAL REPORT

October 1, 2004 – October 31, 2009
Contract Number: 121-C-00-04-713

October 31, 2009
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ACCESS TO CREDIT INITIATIVE
UKRAINE & MOLDOVA

FINAL REPORT - UKRAINE

Contract Number: 121-C-00-04-00713

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ACRONYMS AND ABBREVIATIONS

AKK	Debt Management Agency of Hungary
ATCI	Access to Credit Initiative
AUB	Association of Ukrainian Banks
AUC	Association of Ukrainian Cities
CD	Compact Disk
CIS	Commonwealth of Independent States
CLC	Commercial Law Center
CLPF	Certified Leasing Professionals Foundation
CLS	Certified Leasing Specialist
CML	Certified Mortgage Lender
COP	Chief of Party
DCOP	Deputy Chief of Party
EBRD	European Bank for Reconstruction and Development
FINREP	Financial Sector Rehabilitation Program
FNBCH	First National Bureau of Credit Histories
FSR	Financial Services Regulator (State Commission for Regulation of Financial Services Markets in Ukraine)
GDP	Gross Domestic Product
GOU	Government of Ukraine
IBCH	International Bureau of Credit Histories
IBSER	Institute for Budgetary and Socio-Economic Research
IFC	International Finance Corporation
IMF	International Monetary Fund
IRPF	International Real Property Foundation
ISIN	International Securities Identification Number
ISRS	International Standard on Related Services
IT	Information Technology
IUE	Institute for Urban Economics (Moscow)
IVS	International Valuation Standards
KfW	Kreditanstalt für Wiederaufbau (German government-owned development bank)
LIBOR	London Interbank Offered Rate
LTV	Loan to Value (Ratio)
MFF	Municipal Finance Facility
MLS	Multiple Listing Service
MOF	Ministry of Finance
NBU	National Bank of Ukraine
NGO	Nongovernmental Organization
OECD	Organization for Economic Co-operation and Development
OVDP	Internal State Loan Bonds
PADCO	Planning and Development Collaborative International; acquired by AECOM in 2004
PD	Primary Dealer
PTAP	Programmatic Technical Assistance Partnership
repo	Repurchase Agreement
SAII	State Agency for Investments and Innovations
SMI	State Mortgage Institution (Ukraine)
SSMSC	Ukraine securities commission
STA	Single Treasury Account
UAH	Ukraine Hryvnia
UAIB	Ukrainian Association of Investment Businesses
UBCH	Ukrainian Bureau of Credit Histories (PrivatBank)
UNIA	Ukrainian National Mortgage

URA	Ukrainian Realtors' Association
USAID	US Agency for International Development
USCLS	Ukrainian Society of Certified Leasing Specialists
USD	US dollar
UTO	Ukrainian Society of Appraisers
UUL	Ukrainian Union of Lessors

EXECUTIVE SUMMARY

The Access To Credit Initiative was a five-year, multi-faceted project designed and funded by the US Agency for International Development (USAID) to help attain the Ukraine Mission's overall goal: Increased social and economic well-being of all Ukrainians and Moldovans within a framework of democratic governance. Specifically, USAID/Ukraine's objective for ATCI was to assist Ukraine in achieving increased economic growth by improving access to credit in key areas of the financial sector—mortgage lending and financial leasing; secondary markets for sovereign, sub-sovereign and mortgage-covered bonds—and by developing credit bureaus to support and accelerate the growth of credit.

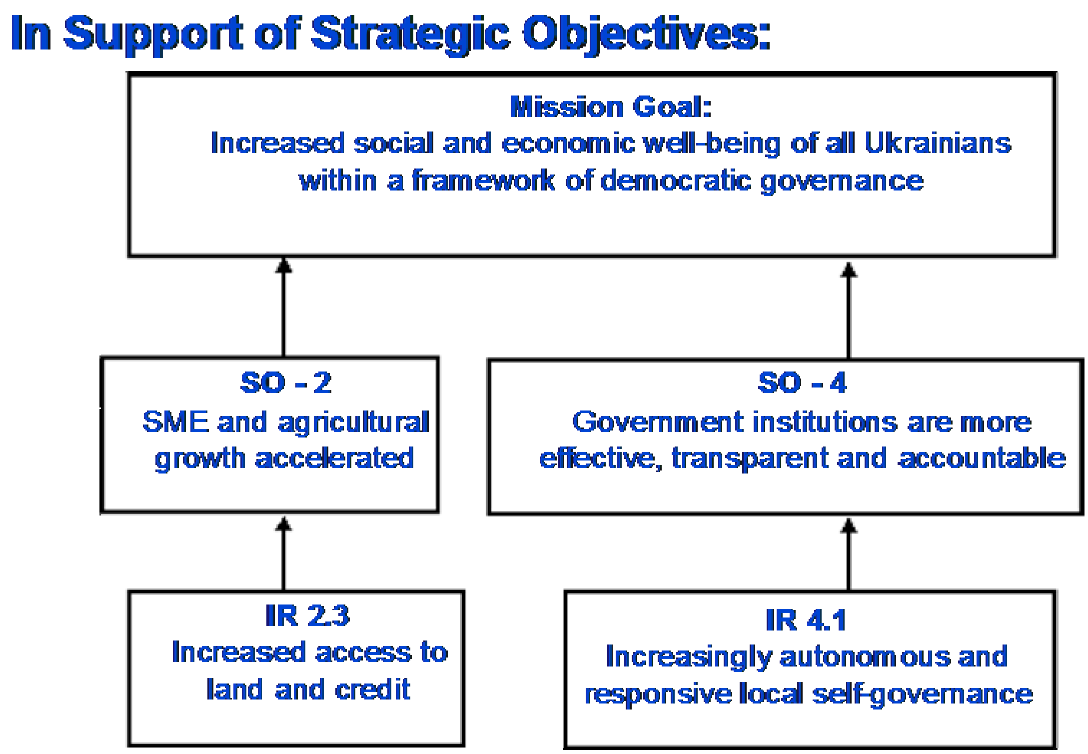


Figure 1. Strategic Objectives

By design, ATCI had five major components: Mortgage, Fixed Income, Credit Bureau, Financial Leasing, and Municipal Bonds. ATCI's mandate to promote Gender Equality was assiduously applied throughout all component activities.

The Pragma Corporation implemented the Access To Credit Initiative for USAID during the period October 2004 through October 2009. ATCI was a "Level of Effort" based contract with a total value of $15.739 million.

Complex, multi-year projects like the Access to Credit Initiative are not designed to achieve spectacular results. When they do, there is invariably some exogenous factor at play. A case in point is mortgage origination in Ukraine. At the end of 2004, at the beginning of the ATCI Project, unpaid mortgage balances in Ukraine totaled USD 0.6 billion. At the end of the third quarter in 2008, after four years of concerted ATCI efforts in the mortgage sector, unpaid mortgage balances totaled USD 14.05 billion—an eye-popping increase of 2,242%.

ATCI had forecast outstanding balances of USD 6.0 billion at the end of the project—a healthy tenfold increase from an admittedly low level. But a 23-fold increase requires an explanation. There are two: the Ukrainian housing bubble and the USD-based carry trade, both of which inevitably led to Ukraine's own version of financial crisis.

The astonishing growth in unpaid mortgage balances risks overshadowing ATCI's other, far less spectacular, achievements—introducing International Valuation Standards in appraisal, laying the groundwork for and creating credit bureaus, bringing Ukraine's first covered bond to market—and the myriad of small, but necessary items associated with building sustainable infrastructure in the financial sector. Complex, multi-year projects like ATCI are designed to accomplish a lot of little things. If you get the little things right—all of them—the big things tend to take care of themselves.

THE MORTGAGE COMPONENT

Objective. The objective of ATCI's Mortgage Component was to increase mortgage lending by (1) training mortgage industry professionals, (2) building the capacities of the institutions and associations needed to support active mortgage lending and (3) creating a market in mortgage-covered bonds in which banks refinance their mortgage portfolios at longer terms and reasonable rates.

Results.

Mortgage Lending. Outstanding mortgage balances increased from UAH 10.0 billion at the end of 2004 to UAH 80.0 billion at the end of September 2008, before the financial crisis took hold.

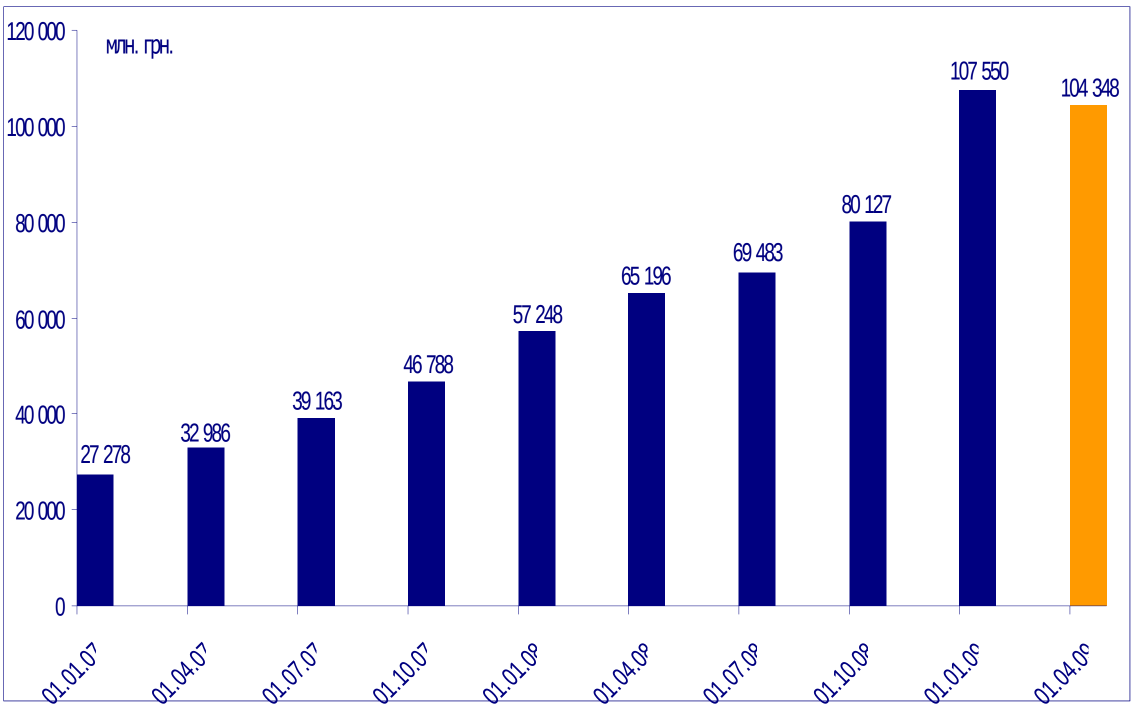


Figure 2. Source: UNIA

Training and developing skills. *ATCI conducted a Certified Mortgage Lender training and certification* program, certifying 113 loan officers working for 44 financial institutions. To make the CML program sustainable, ATCI brought in partners with important stakes in the mortgage sector and trained them to conduct the courses; the Ukrainian National Mortgage Association (UNIA) and the State Mortgage Institution (SMI) now train and certify mortgage loan officers.

With the help of the International Real Property Foundation, ATCI initiated training of Ukrainian appraisers and real estate brokers using uniform training programs based on international standards and began building a realtor-maintained housing price database, which is the starting point for a Multiple Listing Service.

Building institutions and capacity. ATCI helped the Ukrainian National Mortgage Association build its membership and conduct periodic round-tables and seminars

ATCI helped the State Mortgage Institution write its business plan, organize operations and train its staff. ATCI lawyers drafted some 60 operational documents for SMI, and the project assisted SMI in structuring and issuing its first mortgage-covered bond. At the end of September 2008, SMI had purchased more than UAH 2.0 billion in mortgages from 80 participating banks.

Developing a covered bond market. ATCI drafted covered bond regulation for Ukraine's securities commission, with whom it partnered in drafting amendments to Ukraine's law "On Mortgage Securities."

The project advised Ukrgazbank on structuring and issuing Ukraine's first mortgage covered bond—a three-year, UAH 50.0 million issue—which also included the first official use of an "agreed-upon procedure" (IFSR 4400) by Ukrainian banks and auditors.

Impact. ATCI made significant progress in building Ukraine's mortgage lending infrastructure. The project trained mortgage lenders; wrote covered-bond legislation and regulations; and helped build the national realtors' association, the national mortgage association, and a state-owned mortgage refinance facility. In addition, through the efforts of ATCI, a UAH 50 million, three-year covered bond was brought to market. The global financial crisis has devastated Ukraine's primary and second mortgage markets. But the infrastructure ATCI helped put in place will survive the "creative destruction" of the crisis, and the mortgage markets will eventually revive.

FIXED INCOME COMPONENT

In developed economies, it is standard procedure for the government to sell domestic bonds to broker-dealers at market rates at pre-announced auctions. This was not the case in Ukraine before ATCI.

Objective. The objective of ATCI's Fixed Income Component was to assist the GOU in developing a long-term government debt securities market and its corresponding yield curve, which would serve as the benchmark for pricing corporate and other fixed-income securities in Ukraine.

Results. Figure 3 shows the growth in the share of UAH-denominated debt as domestic government securities (OVDP) during the five years of the ATCI project.

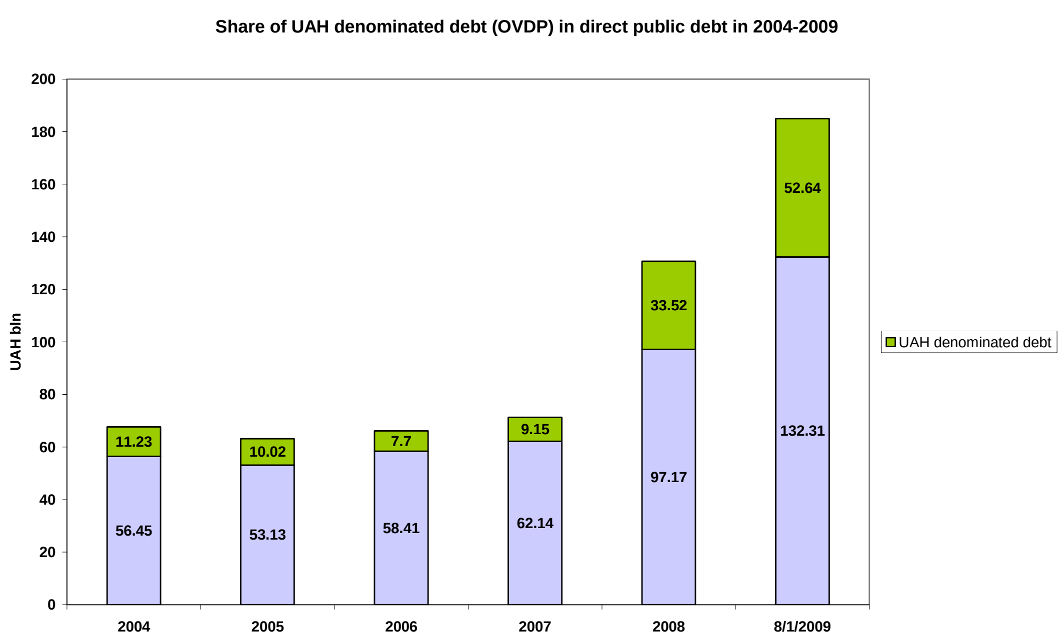


Figure 3. Share of UAH-denominated debt (OVDP) in direct public debt, 2004–2009

Networking and brainstorming. ATCI held informal Saturday sessions to discuss the major macroeconomic problems in Ukraine. The sessions were attended by the Deputy Minister of Finance, the IMF representative, the representative of the US Treasury and high ranking executives of major commercial banks. It was during these sessions that the major problems with domestic issuance and debt management in Ukraine were worked out, and Ministry of Finance was convince to begin selling domestic bonds at market rates at pre-announced auctions to a cadre of broker-dealers.

Persistance pays off. It was an uphill struggle to convince the Government of Ukraine to sell bonds at market rates, but ATCI knew that if the government bond market was not exactly right, none of the other interest rate structures—from deposit rates to rates on long term mortgages—could be exactly right either.

Impact. The issuance of government bonds with up to three years maturity at market rates is a good beginning for Ukraine's fixed-income market. In the short-term, Ukraine's financial crisis will probably obscure the impact of the government bond initiative promoted by ATCI. At some point, however, Ukraine's established government bond market will allow the country to further grow and enjoy the benefits of its financial sector. If the MOF continues to issue bonds at rational rates and at ever longer maturities, it will eventually construct Ukraine's government bond yield curve—the benchmark rate structure against which all rates are measured. The government yield curve will rationalize commercial rate structures in the country, removing the uncertainty of price discovery, especially for longer term corporate issues. Persuading the Ministry of Finance to sell at market rates is probably ATCI's single most powerful and enduring achievement.

MUNICIPAL BONDS COMPONENT

Throughout the former Soviet Union, central planning left a legacy of centralized budgetary finance for all government entities, including cities and oblasts. Installing a more efficient market system of budgetary finance for cities and oblast entails dismantling legal and financial structures—to say nothing of the mindset—that have been in place for decades.

Objective. To increase the amount of local investment in support of essential infrastructure and services.

Results. ATCI provided direct assistance to four cities (Ivano-Frankivsk, Berdyansk, Lugansk, and Lviv) in issuing a total of UAH 137.0 million in municipal bonds, representing some 12% of all municipal issuance during the life of the project. The small amount of total issuance is explained by the fact that the project's focus was on smaller municipalities. In addition to directly assisting the four cities, ATCI provided consulting and advisory services to at least five other small municipal issuers. It lobbied persistently, though unsuccessfully, for the creation of a pooled finance facility (municipal finance facility) that could provide small and medium-sized cities with additional funding sources.

ATCI drafted amendments and additions to the Procedure for Effecting Borrowings to Local Budgets approved by the Decree of the Cabinet of Ministers of Ukraine dated 24 February 2003 # 207, which were adopted by the Cabinet of Ministers on 17 July 2009.

Impact. The lives of the citizens of these municipalities were improved through the use of the proceeds of the bonds for road repairs, roof repairs for residential housing, improvements to street lighting, development and reconstruction of housing and municipal utilities, and other cities' needs. With ATCI assistance, the issues from these municipalities and others from cities that have used the ATCI bond issuance technology have precipitated an emerging asset class suitable for investment by pension funds and insurance companies.

FINANCIAL LEASING COMPONENT

Objective. The primary goals of the Financial Leasing Component were to create a supportive environment for modern financial leasing and provide specific technical advisory and training assistance in order to increase access to credit throughout Ukraine. The two major activities implemented to attain these goals were (1) conducting the Certified Leasing Specialist (CLS) program and (2) providing domestic and international advisory services to both local lessors and foreign investor groups interested in entering the Ukrainian Financial Leasing Market.

Results. When ATCI began, the lease penetration rate (i.e., the percentage of all investment in fixed assets financed through leasing) was less than 1%; at the end of Q3 2008, before the onslaught of devaluation and financial crisis, the lease penetration rate had risen to 7.7%.

Providing technical assistance. Importing capital and international expertise is the most efficient way to build leasing capacity in the shortest amount of time. ATCI advised international leasing firms on how to successfully operate in the Ukrainian legal, tax and regulatory environment.

Building skills and capacity. The ATCI addressed the shortage of local leasing professionals by developing and conducting a Certified Leasing Specialists (CLS) training program. ATCI also set up an NGO, Certified Lease Specialist Union, that controls the CLS training and certification program. At the end of the Project, there were 104 Certified Leasing Specialists representing some 30 leasing companies in Ukraine.

The project also established the Ukrainian Society of Certified Leasing Specialists (USCLS).

In 2009, ATCI published "The Leasing Manual," a 388-page book of detailed instruction on setting up and operating a leasing company in Ukraine. The manual is now used as a text book in finance courses at major universities in Ukraine.

Creating an enabling environment. ATCI worked with various leasing stakeholders to present recommendations to the Cabinet of Ministers of Ukraine and the FSR for the: 1) elimination of conflicting definitions and legal treatment of leasing in Ukraine's commercial code, relative to the civil code and law on financial leasing; 2) elimination of unequal tax treatment of leasing versus comparable forms of financing; 3) introduction of accelerated depreciation of equipment for tax purposes.

ATCI worked with the Ministry of Economy prompting them to initiate the Government Program for the Development of the Leasing Industry for 2006-2010. ATCI was included in the working group under the Cabinet of Ministers of Ukraine to develop the document and present it for approval at the Cabinet of Ministers level.

In August 2008, ATCI was invited to become a permanent member of the Leasing Commission that was being set up within the Ukrainian League of Industrialists and Entrepreneurs.

CREDIT BUREAU AND CREDIT RATINGS

Modern banking and credit markets demand an unprecedented degree of information transfer and transparency—two phenomena rarely associated with the Soviet society Ukraine abandoned less than 20 years ago. Credit bureaus (and, in a specialized sense, credit rating agencies) are the engines driving information transfer and transparency. Without them, access to credit at almost every level is limited or constrained.

Credit Bureau Objective. The purpose of the credit bureau component was to lay the ground work for, help create and promote the use of credit bureaus.

Results. When ATCI began work in October 2004, Ukraine had no credit bureaus. By project's end, there were five licensed credit bureaus, two of which were directly assisted by ATCI and one of which was operated by international credit bureau operator Credit Info.

Setting the legal and regulatory framework. ATCI worked with the Ministry of Justice to draft regulation on the inspection and supervision of credit bureaus and participated in a Ministry of Justice working group to ensure the implementation of the law "On Organizing the Formation and Circulation of Credit Histories."

Developing skills and capacity. In June 2007, at the request of the Union of Industrialists and Entrepreneurs, ATCI conducted a seminar on financial leasing and credit bureau issues in Simferopol.

Credit Rating Objective. To promote a transparent credit rating industry in Ukraine. The focus during the last part of ATCI was to eliminate mandatory credit rating requirements through amendments to provisions of related legislative documents. A secondary goal was to draft a credit ratings law that stipulates the activities and describes the regulation of credit rating agencies.

Best International Practice. In 2006, as part of the ATCI program evaluation process, ATCI commissioned a white paper, Ratings in Ukraine. The paper, prepared by an international expert consultant and presented in November 2006, reflected a thorough review of and recommendations based on the on the international credit rating industry. The major conclusion was that mandatory credit ratings on fixed income issuances are not the best international practice.

Results. The credit rating sub-component of ATCI was successful insofar as domestic credit rating agencies were established and international credit ratings accepted, and mandatory credit ratings were eliminated for some activities. However, as described below, ATCI urged the SSMSC to authorize more domestic credit rating agencies and also lobbied to have the mandatory credit rating requirement totally eliminated in conjunction with the adoption of a new law on credit ratings.

Impact. The subprime crisis in the US is a good measure of the impact of credit bureaus and credit rating agencies on an economy. Had US banks not ignored credit histories and credit scores at the height of the housing bubble, some USD 2.0 trillion of mortgages—about 20% of unpaid mortgage balances in 2007—would not have been written, and there would not have been a subprime crisis. Likewise, had credit rating agencies properly rated "Super Senior CDOs" and other mortgage-backed securities, there would not have been a US banking crisis.

GENDER COMPONENT

ATCI seized opportunities to identify and address gender bias in all training and professional development activities Post-event analysis was conducted to understand the reasons for underweighting when it occurred. In Ukraine, 51% of the graduating Certified Mortgage Lenders and Certified Leasing Specialists were women.

SUMMARY OF RESULTS ACHIEVED

MORTGAGE LENDING

Project Results: Establishment of a viable, effective, and efficient mortgage lending sector

Result Statement	**Certified Mortgage Lender (CML) Program Introduced**	**Narrative Analysis:** CML training covers the basics of mortgage lending, risk management and the role of the secondary market. Personnel who receive such training and work in banks contribute to increased mortgage origination and overall growth of the mortgage market. CML training is expected to become sustainable mid-2008 through the use of private training providers. Mortgage activity came to a virtual standstill by the end of 2008 with the global financial crisis.					
Performance Measurement:	Number of Certified Mortgage Lenders (CML)	**Baseline data and year 2004**	**2006**	**2007**	**2008**	**Sept 2009 (no change)**	**End-of-project target 2009**
Indicator (1)	Number of Certified Mortgage Lenders	Zero	65	96	113	113	150

Indicator (2)	Number of banks that employ CML trained loan officers	Zero	28	41	44	44	35 banks
Indicator (3)	Number of CML trained practitioners who are women	Zero	26	43	56 (50%)	56 (50%)	75 (50% of 150)

Result Statement	**Banks have undertaken mortgage lending**	**Narrative/Analysis:** Increased mortgage lending contributes to economic growth and improved standards of living. Additionally, the increased availability of mortgages releases home equity that can be used for funding small and medium businesses. Mortgage lending as a percentage of GDP is used by mortgage experts worldwide as a way to measure of mortgage market development.					
Performance Measurement:	Outstanding dollar value of mortgages originated	**Baseline data and year 2004**	**2006**	**2007**	**2008**	**Sept 2009**	**End-of-project target 2009**
Indicator (1)	Volume of mortgages	$600 million	$2.891 billion	$11.3 billion	$14.3 billion	$12.5 billion (est)	$6.2 Billion
Indicator (2)	% of GDP	0.9% of GDP	3.1% of GDP	8.0% of GDP	8.3% of GDP	12.29% (est)	5.4% of GDP

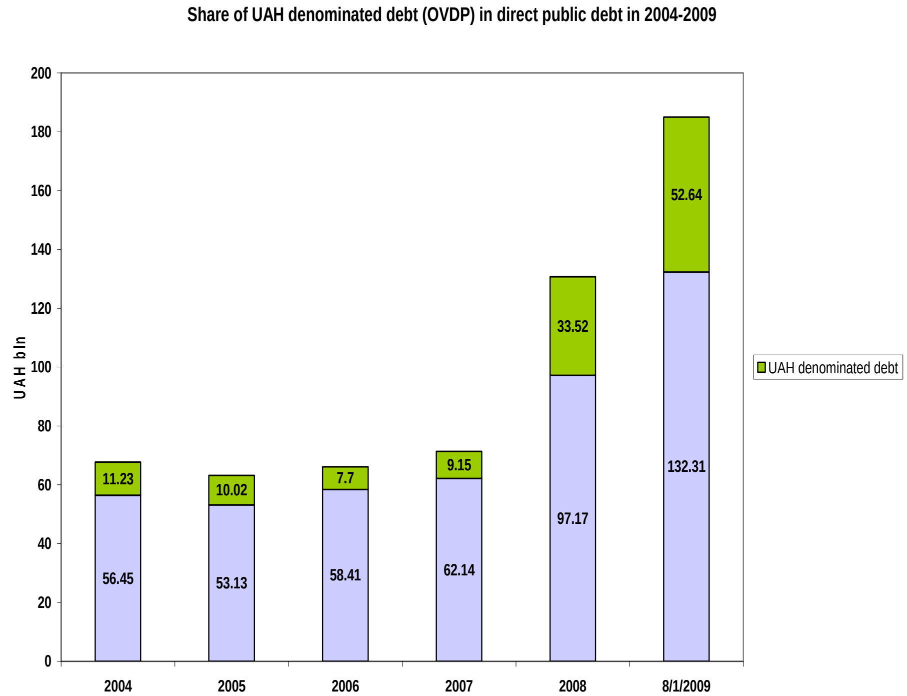
Result Statement	**Mortgage covered bonds are available**	**Narrative/Analysis:** Securitization of real estate collateral through the issuance of mortgage bonds accomplishes two major objectives: 1) it provides longer - term liquidity for banks that can be re-lent for mortgages and 2) it provides secure and tradable instruments for institutional investors. Passage of the mortgage bond law puts the legal framework in place enabling the preparation of pilot issues. In 2007 banks in Ukraine issued both RMBS and covered bonds. Both have differing advantages for investor and issuer alike. RMBS move mortgage assets of bank balance sheets mitigating capital adequacy requirements for banks. Covered bonds remain on a bank's balance sheet and pay principal and interest in bullet form. The latter is ideal for pension funds and insurance companies. Both types of issuance contribute to overall economic growth through increased lending in housing, construction, and the home materials market. Both forms of issuance contribute to the release of equity that can be used for starting new businesses.					
Performance Measurement:		**Baseline data and year 2004**	**2006**	**2007**	**2008**	**Sept 2009**	**End-of-project target 2009**
Indicator (1)	Passage of mortgage bond law	No	Yes	Yes	Yes	Amended Law submitted to Rada	N/A

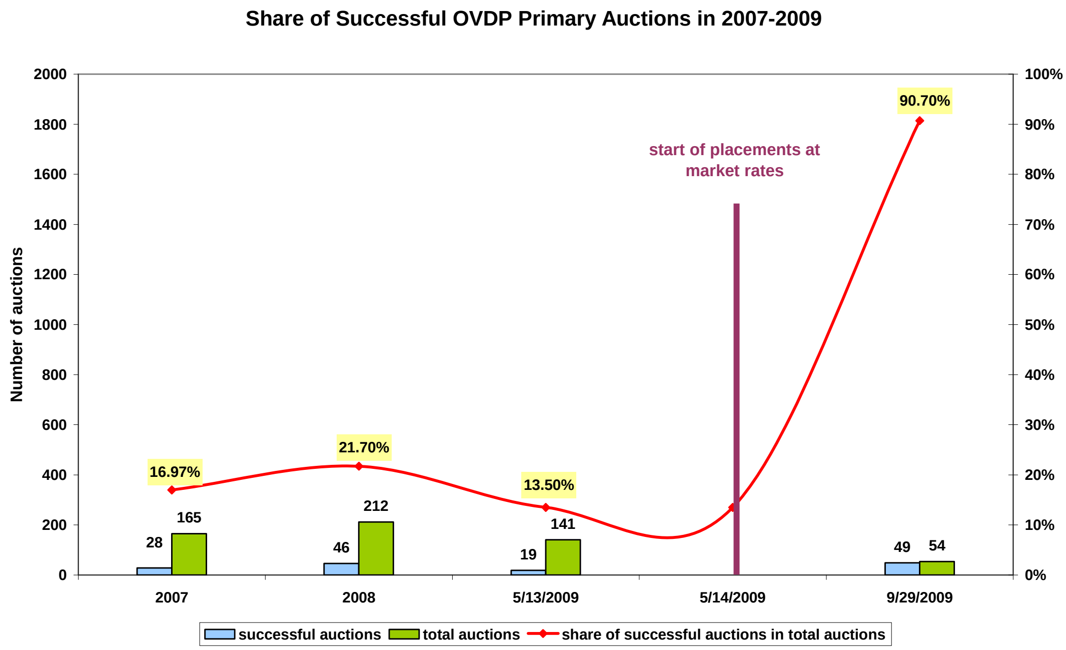
Indicator (2)	Number of financial institutions issuing mortgage – backed bonds	0	0	2	4	4 (cumulative)	3
Indicator (3)	Volume of domestic and international mortgage – backed bonds	0	0	$190 million	* $244 million	$244 million	$50 million

*Privatbank's securitzation, $180 million; Ukrgasbank; Khreschatyk Bank; State Mortgage Institution covered bonds, $64 million

FIXED INCOME

Summary Results: Expanding share of Ukrainian domestic government debt and increasing successful auctions





MUNICIPAL BONDS

Project Results: To increase the volume of local investment in support of essential infrastructure and services

Result Statement	**Issuance of pilot municipal bonds in Ukraine**	Bank lending is not available to municipalities for infrastructure improvement. As a result of this bond issues, Ivano-Frankivsk has installed street lighting around the city; Lviv is using proceeds from its bond issuance for energy saving, the reconstruction of roads, utilities and street lightening; Lugansk for construction, the purchase of technical equipment, reconstruction of heating, street lightening, and tree planting along municipal streets. Berdyansk is using its proceeds to reconstruct housing, roads and street lightening. Four other small-medium sized cities have now issued bonds. More are preparing to do so. The "technology" of bond issuance is spreading among the target group of cities.					
Performance Measurement:	Number of municipal bonds by first-time issuers	**Baseline data and year 2004**	**2006**	**2007**	**2008***	**Sept 2009****	**End-of-project target 2009**
Indicator (1)	Number of cities issuing bonds with ATCI help.	Zero	1 (Ivano-Frankivsk issue UAH 5.5M bond)	4 • Lviv Series A UAH 50M • Series B UAH 42M bond • Lugansk UAH 29.3M bond • Berdyansk UAH 10M bond	2 (09/08) • Lviv Series C UAH 200M Bond • Energodar UAH 10 M Bond	2 • Lviv Series C UAH 300M Bond • Energodar UAH 10 M Bond	2

* Bond issuances are in progress. City of Lviv approved the bond, got approval by the Ministry of Finance, registered at the SSMSC. City of Energodar is preparing documents for MinFin's approval and selection of an underwriter.
** City of Lviv received the first tranche of UAH 100M from Ukreximbank. City of Energodar is negotiating with potential underwriters (fixed underwriting).

FINANCIAL LEASING

Project Results: Supportive environment for modern financial leasing is created

Result Statement	**Build Capacity of Market Participants**	**Narrative Analysis:** Development of Certified Leasing Specialists (CLS) and establishment of the Ukrainian Society of Certified Leasing Specialists (USCLS) will address the shortage of leasing professionals and increase the capacity of the industry to grow. * Leasing Penetration Rate is calculated by dividing the amount of overall **new** leasing business (provided by FSR) by investment in fixed assets excluding investment in private dwellings (provided by State Statistics Committee). NOTE: due to financial and economic crises, numbers are down in 2009.					
Performance Measurement:	Establish a Certified Leasing Specialist (CLS) Program in Ukraine.	**Baseline data and year 2004**	**2006**	**2007**	**2008**	**Sept 2009**	**End-of-project target 2009**

Indicator (1)	Total number of Certified Leasing Specialists (CLS)	0	16 as of 9/06	67	95	104	50
Indicator (2)	Number of Leasing companies employing Certified Leasing Specialists	0	7	22	28	30	20
Indicator (3)	Annual volume of **new** leases	$165 Million	$270 Million	$2.3 Billion	$1.3 Billion	$202 Million(as of 06/09)	$1.35 Billion
Indicator (4)	Leasing Penetration Rate (% of all investment in fixed assets financed through leasing)*	Less than 1%	1.5%	7.7%	4.1%	3.1%(as of 06/09)	6%

Result Statement	**Imported Capital and Know-How into the Ukrainian Market**	**Narrative Analysis:** ATCI continues to work with internationally recognized lessors by providing them with market information that highlights the opportunities in Ukraine, to assist in due diligence, in order to escalate market entry y advising on how to successfully operate in the Ukrainian legal, tax and regulatory environment. Importing capital and international expertise is the most efficient way to build leasing capacity in the shortest amount of time.					
Performance Measurement:	Number of foreign entries in Ukraine	**Baseline data and year 2004**	**2006**	**2007**	**2008**	**Sept 2009**	**End-of-project target 2009**
Indicator (1)	Number of major foreign equipment lessors operating in the Ukrainian Market	0	6	10	10	10	10
Indicator (2)	Number of foreign investors providing debt or equity funding to lessors in Ukraine	0	2	3	4	4	5

Result Statement	**Increased Capacity at Enterprise Level through Consultancy Services**	**Narrative Analysis:** ATCI is working with existing domestic and start-up leasing companies to institutionalize risk management practices and increase the competitiveness of lease products. This is especially relevant to resident distributors of agricultural equipment who have product but need the increased capacity leasing offers to increase sales. NOTE: due to financial and economic crises, numbers are down for 2009.					
Performance Measurement:	Number of private companies offering financial leasing	**Baseline data and year 2004**	**2006**	**2007**	**2008**	**Sept 2009**	**End-of-project target 2009**

Indicator (1)	Number of lessors registered with the Financial Services Regulator as a provider of financial leasing and that actually concluded financial lease transactions	30	54	80	85	70	60

Result Statement	**Credit Information Company (CIC) established**	**Narrative Analysis:** A credit bureau cannot be successful without the use of an international operator and no international operator will operate in a new market without a thorough understanding of market conditions. To procure a successful outcome, ATCI prepared a business plan and tender documents that resulted in selection by the First National Bureau of Credit Histories of an internationally recognized operator.					
Performance Measurement:	Operational Credit Bureau	**Baseline data and year 2004**	**2006**	**2007**	**2008**	**Sept 2009**	**End-of-project target 2009**
ndicator (1)	Credit Bureau is registered	None	4	4	5	5	N/A
Indicator (2)	Business plan is completed	None	Completed; distributed to all interested parties	N/A	N/A	N/A	N/A
Indicator (3)	International operator is selected	None	One selected for 2 bureaus	One Selected for 2 bureaus	One selected for 2 CBs	One selected for 2 CBs	N/A

CREDIT BUREAU

To establish a credit information company (CIC; Credit Bureau) based on international best practices

Result Statement	**Increased capacity of participating banks**	**Narrative Analysis:** There is continued need to develop a credit bureau by assisting the market to understand the importance of sharing data - ideally with a single credit bureau in Ukraine. Currently, two credit bureaus are operating in accordance with international practice. The financial sector is too small and underdeveloped to have more than one effective credit bureau at this time - unlike in the US which has three major credit bureaus. This will contribute to expanding affordable credit to SMEs because a credit bureau helps lenders asses the risk of default: low risk = low interest rates etc. The ability to provide such information contributes to the efficient allocation of capital and economic growth. A comprehensive awareness campaign that covers both general public and banking sector specialists) is expected to boost the development of credit bureau industry by helping to increase data accumulation and the accuracy of reports, and through the increased use of such reports by lenders.

Performance Measurement:	Credit Bureaus are doing business	Baseline data and year 2004	2006	2007	2008	2009 (June 2009)	End-of-project target 2009
Indicator (1)	Number of credit reports sold on a commercial basis	0	0	0	0 to individual consumers; 64,000/month sold to CB partners on a contracted basis	8 to individual consumers; 15,000/month sold to CB partners on a contracted basis	At least 10 from database containing > 60% of data.
Indicator (2)	Number of Consent Clauses on bank application forms	0%	45% (Estimate)	50% (Estimate)	90% of top 20 banks (Estimate); 39% of all 180 banks (E)	100%of all top banks	> 66% of the banks or the top banks
Indicator (3)	% of consumer accounts that are shared with a single credit bureau.	0	40% (Estimate)	50% (Estimate)	58% (Estimate based on all loans issued by partners of a credit bureau)	60% (Estimate based on all loans issued by partners of credit bureaus)	> 60% in a single database

PROJECT MANAGEMENT

Project leadership personnel throughout the life of the project included the following

Project Team, Ukraine

- David Lucterhand, Chief of Party (COP),
- Barry Pitts, Deputy Chief of Party (DCOP)
- Richard Dvorin, DCOP/COP
- Dennis Grubb, Deputy COP

Subcontractors

Subcontractors (included in Pragma's contract with USAID) included the following:

- Institute for Urban Economics (IUE), Moscow, Russia

INTRODUCTION/BACKGROUND

PROJECT CONTEXT

ATCI's official project launch was delayed three months while the "Orange Revolution" transfixed a restive Ukraine. Ordinary Ukrainians flocked to the streets in protest of the mass falsification of the 2004 Presidential Elections. Ballots were recast. The newly-elected President, Viktor Yuschenko, immediately issued a statement that Ukraine's goal was to push forward with massive legislative and social reforms and to move posthaste towards European Integration. In a gesture of solidarity and support, ATCI was officially inaugurated in January 2005, immediately after the President's statement.

PROJECT OVERVIEW

ATCI operations in Ukraine included the implementation of the core contract for Ukraine (2004–2009) with a value of $ 13.506 million; Moldova buy-in (2006-2009) with a value of $2.233 million and the total value of $15.739 million for ATCI.

USAID OBJECTIVES

The Mission Goal: Increased social and economic well-being of all Ukrainians and Moldovans within a framework of democratic governance.

ATCI Ukraine country activities contributed to the following results in the USAID/Ukraine framework:

- Promoting legal and regulatory reform;
- Developing and strenghening the Ukraine financial sector through development of the mortgage industry, financial leasing, and public finance facilitated by functioning credit bureaus
- Strengthening the legal and regulatory environment to support and sustain growth of secondary market trade (in mortgage-covered securities, municipal securities, and government fixed income securities) that deepens credit markets and expands the availability of capital.

Specifically, USAID/Ukraine's objective for ATCI was to assist Ukraine in achieving increased economic growth by improving access to credit in key areas of the financial sector—mortgage lending and financial leasing; secondary markets for sovereign, sub-sovereign and mortgage-covered bonds—and by developing credit bureaus to support and accelerate the growth of credit.

PROJECT COMPONENTS

The project engaged in "developmental" investment banking and benefits from strong leadership, a clear vision and continuity of purpose, approach, and personnel. ATCI consisted of five major components, around which this report is organized:

- The ***mortgage lending component***, meant to lay a foundation for an efficient real estate and mortgage market, including the development of primary (bank loan origination) and secondary (securities trade) mortgage markets as well as the associated infrastructure;
- The ***fixed income component***, designed to assist the Government of Ukraine (GOU) in developing a long-term (7–10 year) liquid government debt securities market in domestic treasuries and its corresponding yield curve that serves as the benchmark for the pricing of other fixed-income securities in Ukraine;
- The ***municipal bonds component,*** which addressed the critical issue of financing municipal infrastructure development for longer terms by accessing the domestic capital market;
- The ***financial leasing component***, which focused primarily on small- and medium-size enterprises (SMEs) and agricultural entities by demonstrating how leasing can lower the cost of financing, and facilitates the development of the leasing industry throughout the country; and
- The ***credit bureau/credit rating component***, meant to serve as tools to (1) increase consumer access to money and thus enable banks to lend more money for longer periods at lower cost

while providing the opportunity for improved portfolio management, and (2) promote the development of a competitive, fair, and effective credit rating industry in Ukraine.

An additional cross-cutting component of ATCI identified and addressed gender bias and encouraged gender equality. All ATCI training and professional development activities included a gender balance objective during the invitation process as well as in delivery of content.

PROJECT COUNTERPARTS

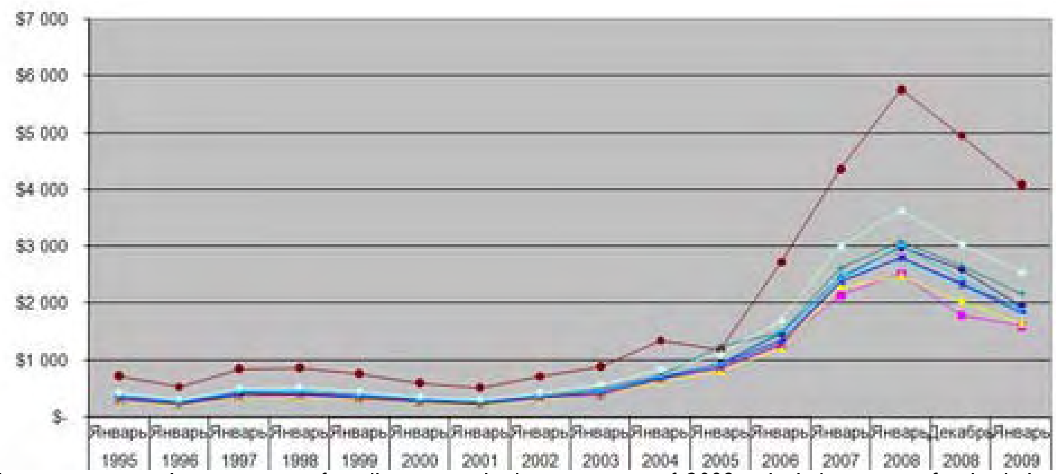
- Ukraine Ministry of Finance
- Ministry of Building, Architecture, and Housing and Communal Services of Ukraine
- Ukraine Ministry of Justice
- Ministry of Economy of Ukraine
- State Stock Market and Securities Commission
- State Mortgage Institution
- Association of Ukrainian Banks
- Association of Ukrainian Cities
- Securities and Stock Market State Commission
- Ukrainian National Mortgage Association
- Ukrainian Realtors Association
- International Bureau of Credit Histories, Closed Joint Stock Company
- Ukrainian Bureau of Credit Histories, LLC
- Ivano-Frankivsk City
- Berdyansk City
- Luhansk City
- Lviv City

MORTGAGE LENDING

UNDERSTANDING THE EFFECTS OF THE MORTGAGE CRISIS

There are many lessons to be learned from the US subprime mortgage crisis. For example, the value of a country's residential housing stock is probably the largest single item in the entire economy—larger than stock market capitalization, larger than gross domestic product (GDP) and several times larger than the national debt. In December 2006, at the height of the US housing bubble, the value of the housing stock (USD 22 trillion) was one-and-a-half times that of GDP, twice the size of the entire US banking system, and two-and-a-half times the size of the national debt. Clearly, a problem with either housing prices or the mortgages that finance houses will have dire consequences for the entire economy.

Ukraine's housing bubble was even more inflated than that of the US. Between 1997 and the third quarter of 2008, housing prices in Kiev increased more than fivefold (Figure 4). In addition, most of the mortgages that financed Ukraine's housing bubble were deeply flawed; more than 70% of the mortgages outstanding in September 2008 was denominated in US dollars, meaning that borrowers—not banks—were running massive currency risk. When the National Bank of Ukraine (NBU) abandoned the Ukrainian hryvnia's (UAH) peg to the US dollar, housing prices simply collapsed. Fortunately for Ukraine, mortgaged housing stock was only a small fraction (about 3.25%) of the total housing stock, so the impact of the housing and mortgage crises on Ukraine's economy has been less severe than was widely feared.



. (Prices shown represent January prices for all years with the exception of 2008, which has prices for both January and December)

Figure 4. Apartment prices in Kiev by region of the city (1995–2009, USD per square meter)
Source: Ukrainian Association of Realtors

Mortgage Component Objective The objective of ATCI's Mortgage Component was to increase mortgage lending by (1) training mortgage industry professionals, (2) building the capacities of the institutions and associations needed to support active mortgage lending and (3) creating a market in mortgage-covered bonds in which banks refinance their mortgage portfolios at longer terms and reasonable rates.

Results. From the end of 2005, a year after the project began, until the third quarter of 2008, Ukraine's primary mortgage market grew eightfold—from UAH 10.8 billion to 80.7 billion (about USD 16.1 billion at the average exchange rate prior to devaluation). However, ATCI was vociferous in its criticism of dollar-denominated mortgages, and the fact that 80% of Ukraine's mortgages were denominated in US dollars suggests that a more powerful dynamic was at work: to wit, foreign direct investment in the banking sector. Large French, Italian, and Austrian banks bought majority interests in the largest Ukrainian banks and used them to conduct a variation of the carry trade, funding dollar-denominated

Ukrainian mortgages in the LIBOR (London Interbank Offered Rate) Eurodollar market. The spreads were simply too wide, the bankers too greedy.

Impact. Despite this, ATCI made significant progress in building Ukraine's mortgage lending infrastructure. The project trained mortgage lenders; wrote covered-bond legislation and regulations; and helped build the national realtors' association, the national mortgage association, and a state-owned mortgage refinance facility. In addition, through the efforts of ATCI, a UAH 50 million, three-year covered bond was brought to market. The global financial crisis has devastated Ukraine's primary and second mortgage markets. But the infrastructure ATCI helped put in place will survive the "creative destruction" of the crisis, and the mortgage markets will eventually revive.

MEASURING THE GROWTH OF MORTGAGE LENDING

At the end of 2008, the value of unpaid mortgage balances was UAH 107.55 billion or 11.3% of nominal GDP. The massive devaluation of UAH against the USD (Figure 5), which began in October 2008 and continued through the end of the year, complicates the conversion of this amount to USD; further, the dramatic collapse in GDP in 2009 thoroughly disguises the real dynamic of the mortgage market during the project's last year. ,

For discussion purposes, we will assume that the value of outstanding mortgages at the end of 2008 is a stock whose value may be converted to USD using the exchange rate on 31 December 2008 (7.655 UAH/USD). That exchange rate yields a USD equivalent of about 14.0 billion. GDP, however, is not a stock, but a flow whose USD value must be calculated using the average exchange rate for 2008 (5.267 UAH/USD), which yields an amount of more than USD 180 billion, making the value of the mortgage stock less than 8% of GDP—considerably less than the UAH equivalent measurement.

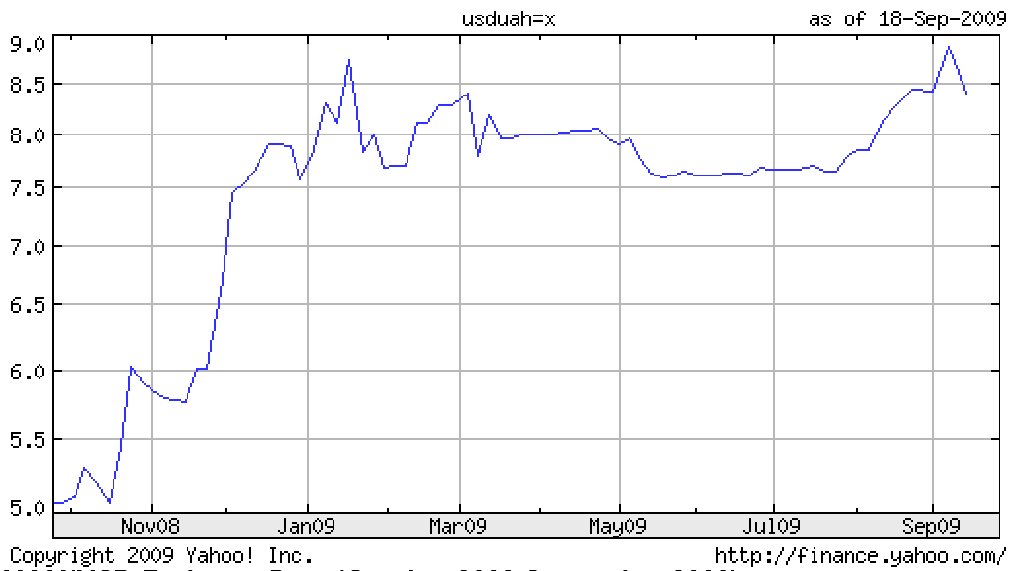


Figure 5. UAH/USD Exchange Rate (October 2008-September 2009)

The value the mortgage stock on 30 June 2009 was about UAH 100.4 billion; for our purposes, we will estimate the fourth quarter 2009 nominal GDP on the basis of the 14% decline from 2008 estimated by the International Monetary Fund (IMF); this yields a value of about UAH 817 billion. Based on the UAH/USD exchange rate on 30 June 2009 (7.676), the USD value for outstanding mortgages as of that date was approximately 13 billion. Using the average monthly exchange rate through June 2009 (7.68) to estimate a fourth quarter GDP of approximately USD 106.4 billion, the outstanding mortgage stock in fourth quarter 2009 is about 12.4% of the GDP.

In short, in spite of the severity of the devaluation and the sharpness of the downturn in Ukraine's economy, outstanding mortgage balances have fallen only about 7.0% from their peak at the end of 2008.

BUILDING CAPACITY

Certified Mortgage Lender Program

Originally developed by the Urban Institute and Moscow's Institute of Urban Economics (IUE), the Certified Mortgage Lender (CML) program has been used throughout the Commonwealth of Independent States (CIS) to train mortgage loan officers. The program is based on a comprehensive study of methodological, economic and legal aspects of residential mortgage lending, including insurance and appraisal, pricing problems, and the evaluation and management of bank risks. Special attention is given to loan origination technology, borrower underwriting, and calculation of loan payments. Participants are introduced to the experiences of the USA, Germany, and other countries with special emphasis on how the emerging mortgage systems in Russia, Kazakhstan, and other transitional economies work. See *Attachment 1: CML Course Agenda* for more details.

Since 2005, in partnership with the State Mortgage Institution (SMI) and the Ukrainian National Mortgage Association (UNIA), ATCI has certified 113 professionals representing 44 banks working in Ukraine (Figure 6). Of these, 54 certificate holders (48%) are women. ATCI also trained a cadre of professional trainers who will ensure the sustainability of the CML program; the responsibility for this program has been transferred to SMI and UNIA. Because of the current financial crisis, the current demand for CML training is negligible and, to date, SMI and UNIA have conducted no CML training courses in 2009.

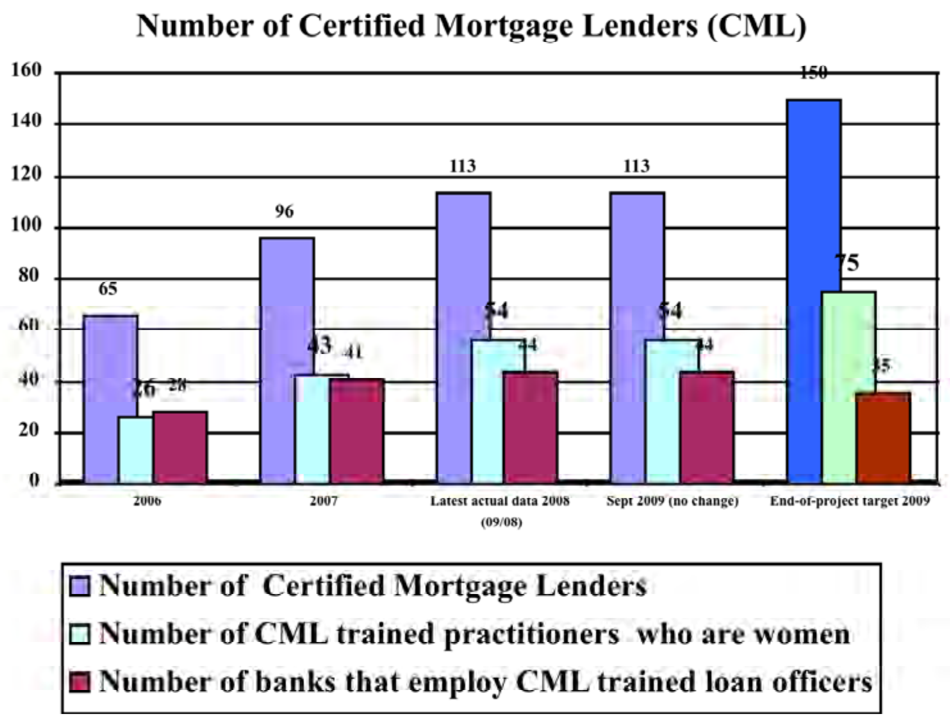


Figure 6. Increase in numbers of Certified Mortgage Lenders, including women

ATCI has also provided technical assistance and a program of financial support to UNIA to develop its institutional capacity, allowing it to offer a broader range of more comprehensive services to its members. As a national mortgage association, UNIA is a private interest group with a dual role: (1) the ongoing professional education of its membership, and (2) the alignment of membership opinion on legislative issues critical to membership's best interest. Accordingly, ATCI financial support programs and technical assistance have focused on:

- *Increased membership*: UNIA attracted new members such as Ukrgazbank, ING Bank, and SEB Bank;
- *Website development*: UNIA launched a website to disseminate schedules and training materials for the CML program and its own periodic publications;
- *Public education*: During 2007–2009, UNIA conducted 13 public education events, including roundtable discussions, press conferences, and seminars;
- *Printed materials:* UNIA publishes a quarterly analysis of the Ukrainian real estate and mortgage markets; it has also published an independent study on the mortgage market in Ukraine (authored by O. V. Pilipets, General Director of UNIA) titled *The National Mortgage System in Ukraine: Foundation and Development of Standardized Conditions*; and
- *International cooperation*: UNIA is developing contacts and cooperation agreements with other international counterparts (e.g., the German Mortgage Association); UNIA experts, with financial help from ATCI, have participated in various international conferences (e.g., *Mortgage Lending in CIS,* held 9–11 November 2005 in Almaty; the 12th International Conference on Mortgage Bonds held 16–17 June 2008 in Warsaw; and the European Mortgage Federation Annual Conference held 21–22 November 2008 in Brussels).

At its peak in 2008, UNIA's membership included 38 banks and other mortgage-related organizations. Since the onset of the financial crisis, membership has declined to 16 organizations, and at the present it appears that UNIA may be unable to continue its current scope of operations without addition donor assistance.

Assistance to the State Mortgage Institution

The relationship between ATCI and SMI actually predates the existence of both the project and the organization. In 2003, the future management core of ATCI attended a meeting in Almaty between Gregorii Marchenko, then Governor of the National Bank of Kazakhstan, and Sergei Tihipko, then Governor of the NBU, to discuss successful implementation of mortgage lending programs in Kazakhstan. At the meeting, Mr. Tihipko voiced interest in seeing an organization similar to the Kazakhstan Mortgage Company established in Ukraine. Despite this strong potential for interaction between ATCI and SMI, the relationship has not been as productive as it could have been especially because of the revolving-door management of SMI. The potential for productive interaction was further curbed during the closing months of ATCI, when President Yushenko lost a political skirmish to Prime Minister Timoshenko, and SMI was saddled with buying and completing the construction of some 28 unfinished apartment houses throughout the country. Thus, at the present time, SMI is in the real estate construction business—way off the mark of its original trajectory.

SMI was established in 2003 by decree of the Cabinet of Ministers; the Ministry of Finance (MOF) has direct responsibility for the SMI, which is regulated by the State Commission for Regulation of Financial Services Markets in Ukraine (Financial Services Regulator or FSR). SMI is a non-bank financial institution whose purpose is to purchase mortgages from participating commercial banks financing the purchases with SMI bond issues secured by the mortgages on its balance sheet and/or an annual GOU guarantee in the amount of UAH 1 billion (see *Attachment 2:Key Fundamentals of Activities of the SMI)***.**

SMI never became a force in the Ukrainian secondary mortgage market for two reasons. First, SMI management was changed at least four times. Management was first appointed first by the Cabinet of Ministers then by the Minister of Finance, of which there have been only two since 2003 (Azarov and Penzenik), but four changes of administration; when a new Minister arrived on the scene, he eventually replaced SMI management with members of "his own team." Second, SMI charter allows it to buy only UAH-denominated mortgages. As noted above, approximately 80% of Ukrainian mortgages are USD-denominated, thus SMI market share could not have exceeded 20% of the total outstanding mortgages. In fact, at the end of 2008, SMI mortgage portfolio consisted of 6,414 loans with a total value of about UAH 2 billion, or about 2% of the total value of Ukraine's mortgage portfolio. These mortgages had been acquired from 80 participating banks, the majority (56%) of which were ranked as "small banks" by the NBU.

Some of the major efforts made by ATCI to assist the development of the SMI are described below.

Business plan. The original business plan for SMI took the better part of two years to draft. In the fall of 2005, ATCI called in two experts—Sally Merrill and Doug Diamond—to assist SMI with the task.

Operations and operational documentation. *In* the spring of 2005, ATCI brought in Maiko Sagindykova, the former chairman of the Kazakhstan Mortgage Company, as a consultant to the SMI. Ms Sagindykova shared her experience in organizing the operations of a mortgage refinance company with the SMI management. Meanwhile, ATCI lawyers and mortgage experts provided SMI management with more than 60 documents ranging in scope from underwriting standards to master agreements and loan documentation for financial institutions.

Conferences and seminars. ATCI, in cooperation with the SMI and the MOF, prepared and delivered (in December 2005) a major conference on the development of the mortgage market in Ukraine for senior GOU leadership. The purpose was to frame policy choices that would determine the direction of market development, including the introduction of covered bonds (See *Attachment 3: Mortgage Conference Agenda)*.

SMI covered bonds. Beginning in 2006, ATCI advised SMI on covered bond issuance; in 2007, ATCI assisted Ukrgazbank in issuing Ukraine's first covered bond (see Section xx, below). On 6 August 2008 ,SMI registered its first mortgage covered bond—a three-year, UAH 200 million bond in seven series or tranches. The bonds were listed on PFTS Stock Exchange in the second tier. The bondholder representative was the State Savings Bank and the servicers were State Savings Bank and State Export-Import Bank. The total value of the mortgage cover at the time of issue was UAH 262 million

Back-up servicing. When SMI buys a mortgage from a commercial bank, it concludes a "serving agreement," under which the bank continues to collect mortgage principal and interest payments from the borrower, calculates outstanding balances, sends out dunning notices, and makes phone calls to delinquent borrowers. In short, the bank continues to service the loan it sold to SMI. Should the bank servicer at some point declare bankruptcy or be forced into liquidation, SMI must find another bank to service the loan. Thus, in advance of problems with its bank servicers, SMI appoints back-up servicers. ATCI provided expert and advisory services on establishing back-up servicing capacity for SMI mortgage portfolio. Consequently, Oshchadbank and Ukreximbank, were selected as the back-up mortgage loan service banks for SMI.

Housing price index. Currently, there is no official housing price index in Ukraine. A number of real estate brokers regularly publish recently traded price levels, which can be used to estimate current prices and construct an historical price index, but that has not yet been done. Such an index would be of enormous value to mortgage bankers, insurance companies, government and academic economists. ATCI discussed with SMI management the notion of developing a pricing index that could provide Ukrainian mortgage market statistics for determining whether loan to value (LTV) ratios were in compliance with SMI guidelines as well as stipulations in the covered bond law. This idea was also discussed at a joint workshop in December 2008, *Estimation of Losses from Defaults on Mortgages According to Basel II*.

Eventually, however, the task for developing a pricing index was handed to UNIA, which has less potential for conflict of interest because it does not transact in the mortgage market. Interestingly, however, one of the most important indices in the US—the FHFA housing price index—is maintained by the Federal Housing Finance Agency, which is also charged with overseeing Ginnie Mae and providing "conservatorship" to Fannie Mae and Freddie Mac.

Assistance to banks. Through ATCI, IUE mortgage specialists were available for direct consultations to banks that participated in the CML program. However, most direct ATCI consultation to banks was provided under the auspices of the covered-bond program, which included only three banks—Ukrsibbank, Ukrsotsbank, and Ukrgazbank. The covered-bond project lasted more than two years.

During 2005 and 2006, ATCI, in cooperation with SMI and UNIA and with the active participation of IUE specialists, drafted and submitted the standards of mortgage lending in Ukraine. The "standard terms and conditions" were discussed with the participants of the CML training program as well as other banks involved in mortgage lending, and recommended for use as the standard mortgage. ATCI included the standard conditions in its draft of the law "On Mortgage Securities." One of the standard conditions was that mortgages should be made in UAH only. Unfortunately, the banks chose to ignore that recommendation.

Appraisers/Brokers Associations

Prior to this project, ATCI management had already worked with the International Real Property Foundation (IRPF) on real estate appraisal and brokerage in several countries. This working relationship was continued in Ukraine, where ATCI called on IRPF to perform a needs assessment of the Ukrainian Realtors' Association (URA) and the Ukrainian Society of Appraisers (UTO), both of which had been established in the late 1990s and were functioning before the ATCI project began.

Training for realtors. IRPF identified the need to develop a unified methodology for the certification of real estate practitioners at the URA and its competitor organization, the Union of Real Estate Companies. With the assistance of the IRPF, a group of Ukraine's leading and most experienced brokers designed a basic training course for those wishing to enter the profession. The effort was coordinated by the URA and resulted in a distance-learning program, which is sold at very affordable price and has become very popular among agents all over Ukraine. The broker group also created a week-long training course, taught by various specialists in relevant areas (e.g., sales, law, accounting); the course is held in 10 major cities on a regular basis. IRPF also worked with the URA and the Union of Real Estate Companies to adapt training from the Russian Guild of Realtors and other appropriate standards.

International Valuation Standards for appraisers. The UTO was interested in providing an optional program to train and certify appraisers according to International Valuation Standards (IVS). George Badescu, Vice President of the IVS Committee, visited UTO a number of times and gave his recommendations regarding materials for preparing an IVS certification curricula. ATCI assisted in obtaining relevant texts from the US and translating these into Ukrainian. Mr. Badescu also gave valuable recommendations regarding membership of the future Certification Board, which is supposed to supervise the standards of training and assigning the designation. The IVS training curricula is currently being finalized and the Certification Board is being created. The training program provides financial support for the UTO and ensures that the existing demand for appraisers will be satisfied. Also, the fact that certified appraisers will be able to value properties according to IVS will provide the appraisal industry with a greater degree of professionalism and make it more competitive.

Development of real estate price transaction database. *The* URA prepared a business plan to create a "multiple listing service" (MLS) database and, through the IRPF, coordinated its efforts with the Real Estate Department of South California to run a regression analysis that would make it possible to get sensible data using relatively few inputs. The proposed price transaction database will serve as a first step towards creation of a full-fledged MLS.The database will be hosted by the URA in cooperation with the International Business Institute, which brings lends the project a professional image.

PROMOTING MORTGAGE-RELATED INSURANCE PRODUCTS

Banks specialize in managing credit risks, whether for commercial or personal loans. However, a number of risks associated with mortgage lending are not credit related. When possible, banks should transfer these non-credit risks to insurance companies specialized in managing the given risk. If a bank does not insure these risks, the bank is in essence self-insuring, and can expect to incur losses once its mortgage portfolio reaches a critical mass. The incidence of claims is a statistical phenomenon and, above a certain sample size, claims will occur at predictable rates.

There are 400 insurance companies and 180 banks operating in the Ukraine, thus the potential exists for a broad spectrum of mortgage-related insurance products. Not surprisingly, however, the use of mortgage-related insurance products by Ukrainian banks is limited.

PROPERTY AND TITLE INSURANCE

Under current Ukrainian law, the only mandatory mortgage-related insurance product is property insurance, which covers loss or damage due to fire, flooding, natural disasters (e.g., earthquakes, lightning), and vandalism. Typically, these policies have no casualty rider for injuries caused to third parties by defects or deficiencies in the property. Generally, when a bank has an insurance subsidiary or closely affiliated insurance partner, it dictates to mortgage applicants where to buy property insurance. Otherwise, it gives the customer a choice of several insurance companies, with which it has agreements in place.

In addition to property insurance, several Ukrainian banks require title insurance—a product which protects against errors in the registration of ownership of the property. When housing prices are low, title insurance is not a high priority; however, when housing prices increase rapidly, as they did in Ukraine, the product takes on added importance. Errors in the registration of ownership rights can cause serious problems and costly delays in subsequent transfers of property. A survey of the title insurance products available in Ukraine reveals that certain companies consider title insurance to be in the category of "financial insurance" while others consider it "property insurance." It is neither, instead belonging to the category of property rights insurance. The insurance companies are not to blame for the confusion; the law "On Insurance" is dreadfully deficient in the area of financial insurance in general and mortgage-related insurance products in particular.

MORTGAGE DEFAULT INSURANCE

Mortgage guarantee insurance covers bank losses occasioned by borrower default, whatever the reason. This type of insurance protects against systemic (economy-wide) risk as well as individual risks, and is thus a good thing to have during a financial crisis. Mortgage insurance is a specific type of financial insurance, the premiums and reserves of which must be calculated by actuaries. Premiums earned from mortgage insurance policies cannot be comingled with premiums from other types of policies. Therefore, a mortgage insurance company is—or should be—a mono-line insurer.

Twelve of the larger insurance companies in Ukraine claim to offer mortgage default insurance, but since this type of insurance is not defined in current Ukrainian laws or regulations, it is unlikely that the product offered by these companies would qualify as mortgage insurance in more developed economies.

Through individual consultations, presentations delivered at UNIA, and a workshop hosted by ATCI, the project proposed developing mortgage default insurance for Ukraine. The idea was not enthusiastically received, primarily because default insurance would have added yet more to a borrower's all-in mortgage cost. Banks feared, and reasonably so, that raising the costs of mortgage would reduce the number of potential borrowers; mortgage lending is, after all, a volume business. For their part, insurance companies understood that introducing real mortgage default insurance would entail rewriting the law "On Insurance" to require more stringent requirements for reserve and premium calculation and other tougher regulations. Finally, the government showed little interest in setting up yet another state-owned institution in support of mortgage lending.

MORTGAGE-RELATED LIFE INSURANCE PRODUCTS

One mortgage-related risk that banks should not need to incur is that of the untimely death of the borrower, by any cause. Insuring the life of the borrower in the amount of the outstanding balance of the mortgage for the term of the loan is a straightforward and relatively inexpensive solution that actually addresses two separate risks: first, the potential nonpayment of the mortgage because of the death of the primary wage-earner in the family and, second, the need to foreclose on a widow who may also have children. The act of foreclosing on a widow with children generates public ill will toward the bank, which is something no bank wants.

ATCI conducted a survey of the 20 top mortgage-lending banks to determine the type (if any) of term life insurance they used. Life insurance was offered in 8 of the 20 banks. In order to evaluate the effectiveness of these term-life insurance products, ATCI analyzed the policies to determine benefits as well as exclusions related to the insured party's mortgage. The conclusions of the analysis were presented in July 2008 at a jointly sponsored ATCI/UNIA roundtable, *Life Insurance: Its Place and Role in Mortgage Market Development in Ukraine*. The roundtable also included a general discussion about other kinds of mortgage-related insurance. Those financial institutions and mortgage companies not already offering mortgage-related (life) insurance products were encouraged to do so. Market participants highlighted the lack of banks' legal ability to charge cash premiums paid to insurants to gross expenses; as a result, the proposal was put forward to create a working group to draft appropriate changes to applicable tax legislation of Ukraine.

DEVELOPING COVERED BONDS

Mortgage lending creates a couple of technical problems for banks. First, mortgages are long-term loans that may stay on a bank's balance sheet for many years; each new mortgage requires the bank to add to its capital base in accordance with bank regulations governing capital-to-asset ratios. This is called the capital constraint problem of mortgage lending. Second, banks are forced to fund long-term mortgages out of short-term deposits, creating what is called maturity mismatch if interest rates on the mortgages are fixed. Widespread and pervasive maturity mismatch caused thousands of small banks and thrifts to fail during the US Savings and Loan Crisis (1982–1990).

Covered bonds remedy maturity mismatch in mortgage lending institutions, but they do not ease the capital constraint. However, this constraint is not as onerous as it may sound. Typically, banks are required to establish Tier I capital reserves for mortgage assets at only 50% of the reserve requirement for other types of loans. Securitization as practiced in the US addresses both problems, but Ukrainian law did not at the time (nor does it now) support securitization. The law "On Mortgage Securities," which had not been passed by the Verhovna Rada at the time ATCI began its work, supports only covered bonds.

Covered bonds: an expedient solution. Covered bonds have a long and remarkably stable history in Europe (and at the time of the ATCI began work in this area, the Ukrainian government aspired to join the European Union). Covered bonds are secured by a pledge of mortgages and other financial assets on the balance sheet of the issuer, who by covenant allows bondholders to periodically monitor the condition of those assets. The monitoring process is organized and overseen by a trustee (or bondholder representative) appointed by the issuer. ATCI determined that it was legally possible to structure covered bonds based on existing legislation without the proposed new law on mortgage bonds. In the spring of 2005, ATCI began working with three large banks—Ukrsibbank, Ukrsotsbank and Ukrgazbank—to prepare covered bond issues.

ATCI efforts to develop covered bonds. The initial work done by ATCI was highly technical. The first task was to identity which mortgage assets on a bank's balance sheet qualified to be included in "the cover"—that is, the mortgage pool securing the face value of the bond issue. The two largest banks—Ukrsibbank and Ukrsotsbank—had over 3,000 mortgages in their portfolios at the time. ATCI worked with bank information technology (IT) specialists to transfer specific fields of data from bank software databases to an Excel file where loan screening and portfolio analysis could be performed. The Excel worksheet calculated the weighted averages of several key characteristics of the mortgage pool—interest rate, months to maturity, original LTV—and on the basis

On 23 January 2007, Ukrgazbank issued Ukraine's **first mortgage covered bond—a three-year, UAH 50 million bond priced to yield 10.5%.** This was the first bond issued under the aegis of the law "On Mortgage Bonds," which was promulgated in December 2005 after more than a year-and-a-half of effort by ATCI to develop mortgage covered bonds in Ukraine. Unfortunately, this historic bond was also unique: it remains the only privately issued mortgage covered bond in Ukraine, even with UAH 104.7 billion of mortgages outstanding. See Attachment 4: Presentation of First Covered Bond Issue by Ukrgazbank.

of these characteristics calculated Average Monthly Prepayment, Macaulay Duration, and Duration with Prepayment. Duration with Prepayment is the most accurate valuation of the true cash flows in a mortgage pool and yields an equally accurate determination of the maturity of the bond required to correct maturity mismatch. It took ATCI and the banks about seven months to complete this phase of preparation, after which the banks were required to continue a monthly analysis of their portfolios, generating a report on the condition of the mortgage pool that would become the basis for the bondholder representative's periodic monitoring of the "mortgage register."

Meanwhile, ATCI began working with the banks' auditors (PriceWaterhouse, Deloitte Touche, et al.) to design an Agreed-upon Procedure, which would satisfy the requirement for periodic monitoring. An Agreed-upon Procedure (International Standard on Related Services [ISRS] 4400) is an auditing procedure of extremely limited scope; agreed-upon procedures are used, for example, to document compliance with deposit insurance requirements or other national bank norms, for which an auditor needs only confirm a bank's calculations. The auditors generally welcomed the potential for new business in the area of bond issuance.

However, in December 2005 when "On Mortgage Securities" was signed into law, ATCI's job was actually made more complicated. The law contains a number of errors and inaccuracies because it was written without the benefit of experience or knowledge of bond mathematics, accounting, and audit. For example, the Ukrainian law refers to the auditing procedure required by periodic monitoring as both an "audit" and a "review"; it cannot, of course, be both. On reading the new law, the auditors got cold feet.

Also as a result of the new law being passed, ATCI had to redirect its efforts to drafting regulation for the Ukraine securities commission (SSMSC). It was agreed with the commission that the draft regulation would attempt to correct some of the obvious errors and inaccuracies in the law. New regulation is, however, subject to review by the Ministry of Justice which, it turns out, was unwilling to go along with the corrections ATCI offered, including the use of an "agreed-upon procedure" instead of an "audit" or "review."

External factors affecting bond issuance. At this time, another dynamic began to significantly affected ATCI's efforts to launch covered bonds in Ukraine. In 2005, Banque Paribas acquired a controlling stake in Ukrsibbank; in 2006, negotiations between Ukrsotsbank and UniCredit Group began. Both of these banks became less interested in issuing covered bonds, which ATCI had insisted should be issued in hryvnia, and more interested in writing mortgages in US dollars which, via their mother European banks, they could fund in London's short-term LIBOR market, deliberately engaging in currency and maturity mismatch to capture the handsome returns offered by the carry trade. Eventually, both banks pulled out of the ATCI covered bonds issuance program, leaving only Ukrgazbank—the weakest of the three banks—as a candidate issuer. Ironically, Ukrgazbank's desire to issue a covered bond was driven by its chairman's belief that bond issuance would attract a European buyer for his bank. That was not the case; Ukrgazbank is now 87% owned by the Ministry of Finance.

Successful issuance of covered bond. Ukrgazbank's mortgage portfolio consisted of about 350 loans that complied with requirements set forth in the new law. Ukrgazbank identified an auditor (Grant Thornton) who both understood ISRS 4400 and wanted to get involved in the potentially lucrative business of agreed-upon procedures for covered bonds. More problematic was finding another bank, not directly involved in the mortgage business, to act as the bondholder representative for the Ukrgazbank issue.

The new mortgage bond law was not helpful in securing a bondholder representative. Several of the most egregious errors in the law occur in the section concerning the bondholder representative, which the law perversely calls the "bond manager." For example, the law makes the "manager" responsible for storing records of the mortgage pool. The records of the mortgage pool consist of paper folders containing the original mortgage application, documentation of the borrower's employment, appraisal of the mortgaged property, and many other related documents; the number of paper folders—that is, individual loans—can number in the thousands. So not only is it unrealistic for the manager to store several thousand loan folders on its own premises, but it is absolutely impossible for the mortgage lender to manage the mortgage portfolio without direct access to all the loan folders at all times. ATCI had to dispel this kind of confusion caused by the new law.

After lengthy discussions among ATCI, Ukrgazbank, and several candidate bondholder representatives, Ukrgazbank secured the services of HVB Bank—a bank with a long history of trustee operations in its home country of Austria. ATCI drafted the investment memorandum for the bond and the tripartite bondholder representative agreement among Ukrgazbank, Grant Thornton, and HVB Bank. During January 2007, ATCI accompanied Ukrgazbank representatives on a road show to the offices of various potential investors. On 23 January 2007, ATCI participated in a presentation and explanation of the bond before a large audience at a major conference center in Kiev. Later the same afternoon, the bond was sold to 15 different private investors. The pilot issue had been accomplished.

Reasons for lack of market development. Mortgage covered bond issuance, however, never accelerated in Ukraine as expected. The commonplace explanation has been that the law is too imperfect to support robust growth of the mortgage covered bond market. That observation is probably valid to some degree; however, in the wake of the financial crisis, a parallel and more powerful reason has emerged. The largest mortgages lenders in Ukraine were majority-owned subsidiaries of large European banks that used their Ukrainian subsidiaries as conduits for a variation of the carry trade. The banks funded themselves in Eurodollars in the short-term LIBOR market and issued 20-year USD-denominated mortgages in Ukraine with a 10 or 11 point spread. After the carry trade began in earnest—about the beginning of 2006—there was little genuine interest in covered bonds among the larger banks. This also explains why the mortgage bond law remains unperfected to this day; it has never attracted a constituency sufficiently large and powerful to force the necessary changes through Parliament. With the financial crisis at full tilt and the mortgage market moribund, it is likely to be some time before interest in the covered bond law revives.

CONTINUING DEVELOPMENT OF MORTGAGE MARKETS: RECOMMENDATIONS

- Continued efforts to make the marketplace more transparent. That includes a data collection program that will characterize the real value of property. Assisting in that effort should be a legislative advocacy program to reduce the taxes on transfer. That is the major impediment for people both signing exclusive listings and/or giving true values at the point of sale.
- Continued financial and technical assistance made available to the Ukrainian Realtors' Association and others that are attempting to put together multiple listing services. Once these are in place, data will be much more readily available and accurate. It will allow banks again to understand the collateral that they are looking when making loans.
- Attention must be focused on the licensing law which continually comes before the legislature. An appropriate one will help the market; an inappropriate one will cause disruption and be deleterious to both the industry and the home buyer and seller.
- USAID could consider an insurance project that incorporates mortgage-related insurance with a revised insurance law.

NEEDS GOING FORWARD POST-ATCI: MORTGAGES AND MORTGAGE COVERED BONDS

- Amendments to Covered Bond Law are in the hands of the SSMSC, along with all of ATCI's and UNIA's comments; the SSMSC will present law to Parliament for adoption.
- UNIA as presented earlier has lost approximately 60% of its membership in 2009; UNIA has accomplished some admirable activities, yet there is doubt for their sustainability.
- SMI was given "changed directions" recently from CabMin, whereas SMI was saddled with buying and completing construction of some fifteen unfinished apartment houses throughout the country. Now SMI is in the real estate construction business—way off the mark of its original trajectory of being a liquidity facility. SMI should get back on track of their original business activities.

FIXED INCOME

Objective. The objective of ATCI's Fixed Income Component was to assist the GOU in developing a long-term government debt securities market and its corresponding yield curve, which would serve as the benchmark for pricing corporate and other fixed-income securities in Ukraine.

Results. Figure 7 shows the growth in the share of UAH-denominated debt as domestic government securities (OVDP) during the five years of the ATCI project.

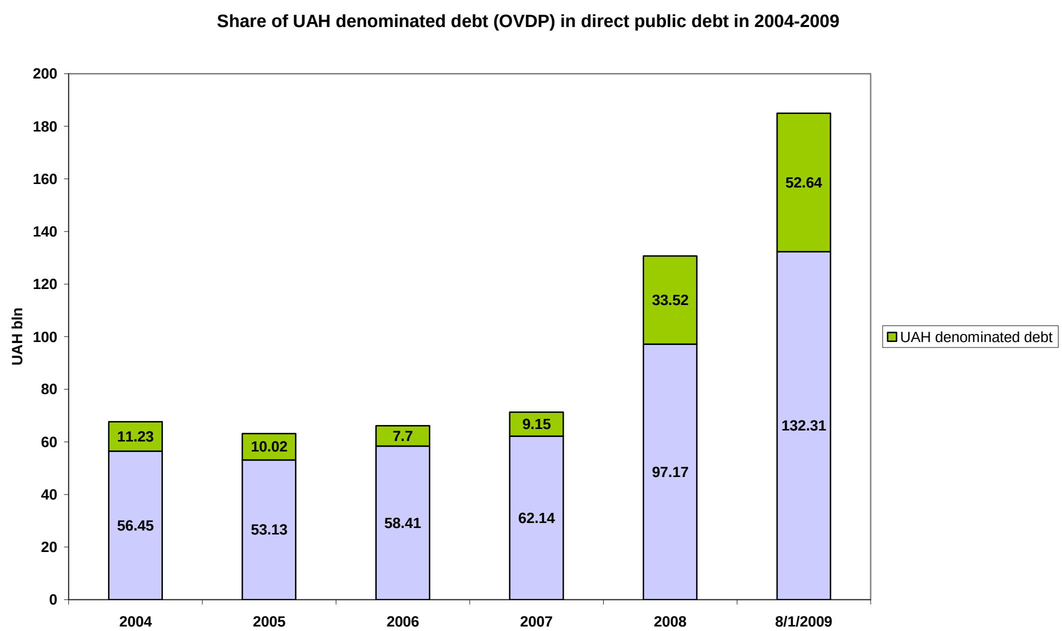


Figure 7. Share of UAH-denominated debt (OVDP) in direct public debt, 2004–2009

Impact. The issuance of government bonds with up to three years maturity at market rates is a good beginning for Ukraine's fixed-income market. In the short-term, Ukraine's financial crisis will probably obscure the impact of the government bond initiative promoted by ATCI. At some point, however, Ukraine's established government bond market will allow the country to further grow and enjoy the benefits of its financial sector. If the MOF continues to issue bonds at rational rates and at ever longer maturities, it will eventually construct Ukraine's government bond yield curve—the benchmark rate structure against which all rates are measured. The government yield curve will rationalize commercial rate structures in the country, removing the uncertainty of price discovery, especially for longer term corporate issues.

Activities. To achieve the objective, ATCI provided GOU with extensive technical assistance using both local specialists and international experts. The main activities and results of this component are described below.

PROMOTING A STRUCTURE FOR THE DOMESTIC GOVERNMENT SECURITIES MARKET

Between 2000 and 2006, aggregate Ukrainian government debt (direct debt and government guarantees) was reduced from 60% of GDP to a bit over 15%. The main factors behind debt reduction were rapid growth in real GDP, disciplined fiscal policy, and, to a lesser extent, the real appreciation of UAH relative to the USD. However, debt managers in Ukraine relied heavily on external debt as a source of government financing, which eventually became a key constraint in the development of domestic financial markets. Further, foreign borrowing posed significant risks both to the budget and—because it encouraged the private sector to borrow extensively in foreign currency as well—to the economy at large.

The cost of interest is lower when external debt is used, but the debt is subject to significant currency risk; moreover, the reliance on foreign markets impedes the development of the domestic market for government securities, which makes it more difficult and risky to introduce any changes in monetary policy.

As early as 2006, ATCI made the GOU aware of the fact that the development of a domestic market for sovereign debt would serve as a catalyst for the growth of other financial markets. The GOU needed to shift its position towards greater reliance on domestic issues and develop domestic capital markets rapidly. The main impediment to this strategy was the practice of issuing domestic government bonds at pre-set rates substantially below market rates.

Debt management forum. To provide some specific guidance and recommendations, ATCI initiated and hosted a debt management forum in March 2007, together with the MOF, the Organization for Economic Co-operation and Development (OECD), and the World Bank. Invitees included senior leadership of the GOU involved in policy formation, market practitioners, and donors with a stake in development of the domestic treasury market. The forum was moderated by the Head of the Debt Management Working Party at the OECD. Representatives of debt management offices from Hungary, Poland, and Turkey presented their countries' experiences in developing sovereign markets. The forum explored what steps the GOU should take to manage its debt requirements efficiently; examined the role *domestic* government debt markets played in efficient capital allocation; and analyzed the institutional framework requisite for market development including the role of primary dealers and the use of pre-announced auction calendars. The following recommendations were made: (1) to reduce the levels of foreign currency exposure to minimize negative impact on the development of the domestic capital market; (2) to introduce a primary dealer system as a reliable mechanism for government borrowings, which would also help to expand the secondary market; and (3) to announce regular and transparent auction schedules with interest rates being determined by supply and demand. See *Attachment 5: Key Conclusions and Recommendations of the Debt Management Forum.*

Saturday brainstorming sessions. In 2008, ATCI started holding regular, informal Saturday sessions that included the Deputy Minister of Finance, specialists from the MOF Sovereign Debt Department, US Treasury advisors, and the IMF local representative, as well as representatives of major foreign investors and potential primary dealers. The attendees discussed concrete steps to be taken for issuance of domestic government securities at market rates and ways to coordinate actions of the MOF and the NBU in the development of government securities markets, in particular, with regard to repurchase (repo) transactions with government bonds.

Reform plan. In response to a request from the MOF in August 2008 for assistance in developing the domestic government debt markets, ATCI, in cooperation with the World Bank (under the aegis of the "Programmatic Technical Assistance Partnership" between USAID and the World Bank), prepared a reform plan for government debt management and debt market development that considered the draft debt management strategy of the MOF. Recommendations from the reform plan, in combination with those from the Debt Management Forum, formed the basis of the *Concept for Domestic Government Securities Market Development in Ukraine for 2009-2013*, approved by the Cabinet of Ministers on 25 March 2009. See *Attachment 6: Concept for Domestic Government Securities Market Development in Ukraine for 2009-2013, March 25, 2009.*

To assist the MOF in implementing the recommendations provided in this concept paper, ATCI subcontracted a technical assistance study to AKK, the Debt Management Agency of Hungary, in early 2009. Working closely with the MOF Sovereign Debt Department, potential primary dealer banks, and institutional investors, a joint ATCI/AKK team focused on analyzing current problems and preparing an action plan to develop the primary market organization (e.g., primary dealer system, issuance program, calendar setting, bidding process, price discovery) and the design of a repo and reverse repo market in government securities, as well as time frames for implementation. See *Attachment 7: Recommendations of AKK Specialists on the Development of the Ukrainian Government Bond Market*.

Persistence pays off. Finally, in May 2009, the MOF changed existing placement terms and started placing domestic government bonds at single-stage auctions with preannounced volumes **at market rates**. As ATCI had been recommending this action for more than three years, it should be viewed as a significant event. The MOF began publishing a schedule that showed placements for the following three months; this encouraged more commercial banks to participate in the auctions, which brought rates down and decreased the cost of borrowing for the government.

Persistence pays off. Finally, in May 2009, the MOF changed existing placement terms and started placing domestic government bonds at single-stage auctions with preannounced volumes **at market rates**. As ATCI had been recommending this action for more than three years, it should be viewed as a significant event.

Issuance of bonds at market rates was a huge step forward in the development of government securities market. It made government bonds an attractive financial instrument. In addition, it paved the way for an effective primary dealer system and a repo and reverse repo market, and was the first step in building a real yield curve upon which other non-governmental debt issuances can be priced. The move to market rates also enabled banks to bid on newly issued government bonds at rates that are competitive; the result so far is that over 90% of the subsequent government bond auctions have been successful (Figure 8). From the time of the first market-rate auctions (14 May 2009) through those held on 29 September 2009, nearly UAH 4.8 billion (about $600 million at the official exchange rate on 2 October 2009) has been raised to finance the GOU budget.

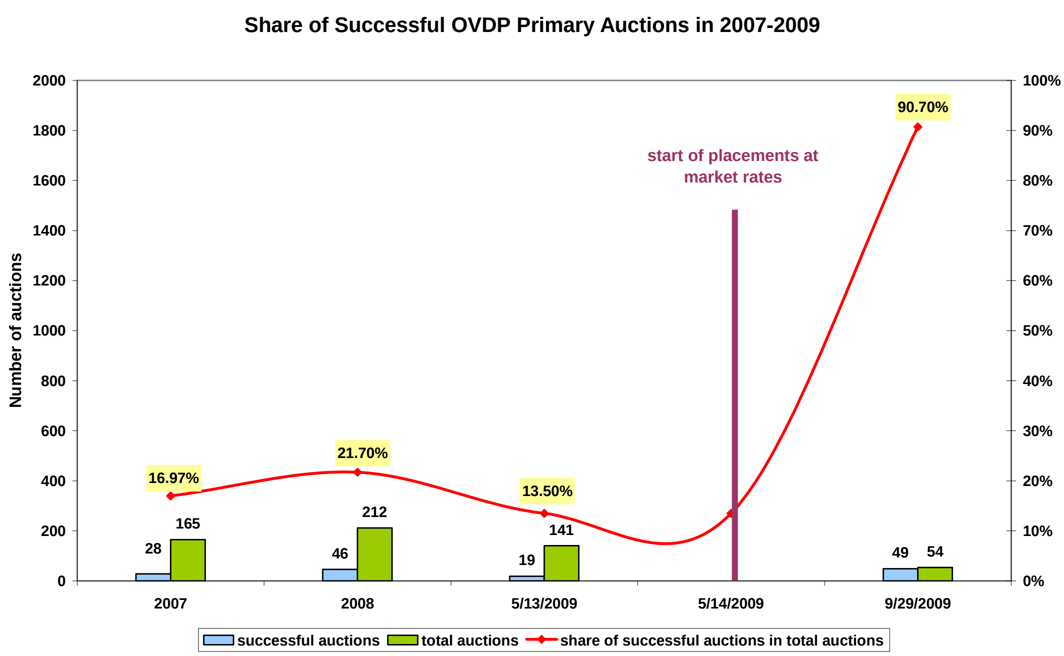


Figure 8. Share of successful OVDP primary auctions, 2007–2009

INTRODUCING A PRIMARY DEALER SYSTEM

In November 2008, the MOF requested that ATCI provide specific technical assistance in developing a primary dealer (PD) system for Ukraine. A PD system is a reliable mechanism for efficient government borrowings that helps maximize cost savings and provides the transparency and liquidity in the secondary market that is needed for Ukraine's developing capital markets.

Laying the groundwork. In response to the MOF request, ATCI, together with AKK specialists, developed selection criteria for and defined the activities of primary dealers; these were later incorporated into the Cabinet of Ministers' Resolution on Introduction of Primary Dealer Institute to the Government Securities Market of Ukraine (14 April 2009) and relevant regulations of the MOF. In particular, ATCI convinced the MOF to downgrade the importance of the size of paid-in charter capital as a selection criterion (the minimum amount was set at EUR 10 million with no points awarded for exceeding this amount), giving preference to the volume of trade in government bonds (to be not less than UAH 1 billion); thus, the range of potential primary dealers was expanded. Special emphasis was put on the role of primary dealers in developing the secondary market for government securities by means of continuous two-sided price quotation, which helps investors fix prices and calculate bond indices, while enabling the debt manager to make financing decisions and price the instruments for more effective issuance.

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During May–July 2009, to help initiate a dialogue between the MOF and potential primary dealers, ATCI had numerous discussions with leading Ukrainian banks to diagnose possible problems related to building of the effective primary dealer system. On the basis of these discussions, ATCI made relevant legislative proposals; these were reflected in the Ministry's orders on the selection and functioning of primary dealers in Ukraine and the model agreement.

Selection of primary dealers. As a result of these efforts, in August 2009, the MOF selected the first five primary dealers. Because a minimum of six primary dealers was required, the MOF announced a new tender to take place in mid-September, at which time four more primary dealers were selected, making a total of nine primary dealers.

Next steps. At the end of September 2009, ATCI asked the MOF to host a roundtable discussion involving the nine primary dealers, the NBU, the exchanges qualified to trade government bonds in the secondary market, and ATCI. The discussions centered on the activities of primary dealers, including their obligations and benefits as PDs. Specific items discussed (which have not yet been agreed on or mandated by the MOF) included the following:

- Status of NBU amendments to primary auction procedure on exclusivity of primary dealers;
- Participation of the State Deposit Guarantee Fund in primary auctions;
- The procedure of two-sided quotations on the secondary market with respect to volumes, securities, exchanges or trading platforms;
- Pending issues of repo procedure; and
- Working committees composed of members drawn from PDs, the MOF, and the NBU to implement policies and improvements related to settlement and clearance, issuance strategy and tactics, and trading practices.

DESIGNING THE REPO AND REVERSE REPO MARKET

The main objective for developing a repo market was to increase the liquidity of government securities, thus making them a more attractive financial instrument. The key impediment was that government bonds were issued at pre-set rates substantially below market yields. Another issue revolved around how to account for the costs to the MOF for issuing at market rates. In Ukraine, the proceeds a MOF bond issue are deposited in the Single Treasury Account (STA) administered by the NBU. However, by law, the NBU is not allowed to pay interest on money held in the STA in the name of the MOF. Therefore, if government securities are issued at market rates, the MOF has no offsetting income to show that blunts the cost of market issuance. In developed economies this is not a problem because the issuance of government securities is always conducted at market rates and, since the government funds are in one coffer, interest earned by the central bank offsets the cost of issuance. In Ukraine, however, the issue was a political one.

To deal with this issue, ATCI suggested that the MOF could show income by conducting reverse repo transactions, thereby putting the money it raised at market prices back into the economy. Unfortunately, that option interfered with the NBU mandate to manage monetary policy and liquidity. Another possible scenario was elaborated during the regular, informal Saturday sessions: the MOF would place any excess balance within the STA with banks that, in turn, would pledge government securities. In case of bank's failure to repay, the bonds would be sold to repay the MOF.

Thus, ATCI focused on elaborating procedures for the MOF to choose counterparts for repo transactions. Model agreements were drafted, and special attention was paid to the transfer of title to pledged bonds; the determination of the percentage discount (haircut) depending upon the maturity of bonds (up to 25%); and the stipulation of rights and obligations of both parties in case of default. Subsequently, those proposals were approved by a Cabinet of Ministers Resolution in June 2009 that entitled the MOF to conduct repo transactions using funds from the STA. Counterparts were chosen on the basis of an open tender conducted by the MOF or an auction held via a trade organizer (stock exchange). Relevant MOF orders were also defined, save for the issue of title transfer which remains substituted by blocking/unblocking procedure by the depository of the NBU and may cause potential problems in the events of default.

ATCI also promoted a strategy whereby Ukrainian city councils could place excess treasury balances against the collateral of municipal or domestic government bonds. The pilot municipal bond cities, as well as cities that had announced plans to issue bonds in 2009, were invited to address the MOF about an initiative to allow placement of municipal interest-bearing bonds below par, if such bonds were placed publicly at a stock exchange. In cooperation with the Institute for Budgetary and Social and Economic Research, ATCI drafted relevant amendments to the Cabinet of Ministers Procedure on Local Borrowing. The amendments were approved by the Cabinet of Ministers on 17 August 2009, and the municipalities were allowed to place their bonds at stock exchanges not only at par value, but below or above par value.

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EXPANDING THE INVESTOR BASE IN GOVERNMENT SECURITIES

During the ATCI assessment of Ukraine's domestic government securities market, it became clear that the institutional investor base is severely underdeveloped. In developed markets, pension funds, insurance companies, and investment funds—all of which have large volumes of money at their disposal and are interested in medium- and long-term investments—form the demand-side of debt markets. However, Ukraine's nascent pension reform industry has a very low asset accumulation; in addition, administrative barriers prevent institutional investors from investing more than 50% of their portfolios in government securities, and the NBU acts as a lender of last resort, owing three-quarters of all government securities issued (Figure 9).

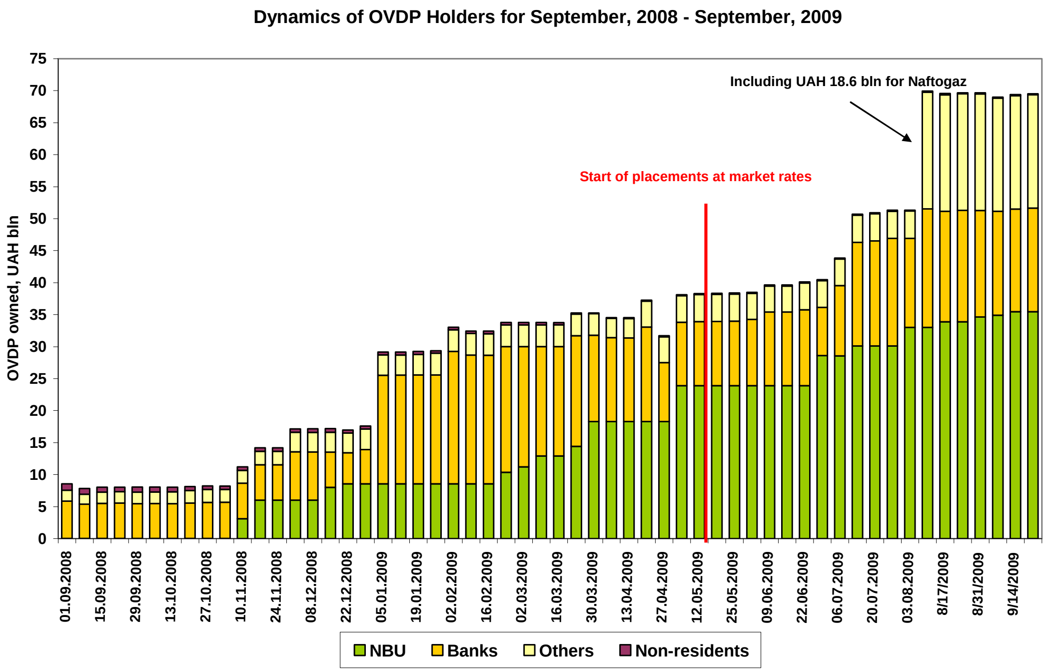

Figure 9. Dynamics of OVDP holders, September 2008 through September 2009

ATCI focused its efforts to expand the investor base on two main issues: the elimination of restrictions for institutional investors and the development of measures to attract retail investors.

In June 2009, the ATCI legal team prepared, and submitted to the State Commission for Regulation of Financial Services Markets in Ukraine, legislative amendments which would allow pension funds, insurance companies, and credit unions to invest in government securities without limitation. These proposals are still under review by the FSR.

ATCI, together with AKK specialists, recommended that the MOF issue retail bonds to attract the so-called "mattress money" of the population, which was estimated at between USD 12-40 billion, and which grew significantly in the second half of 2008 because of lost confidence in the Ukrainian banking system. The MOF was advised to issue bonds with short maturities (up to 1 year) and quarterly coupon payments. Initially, the bonds would be distributed through the State Savings Bank; in the long run, distribution would be through primary dealers. Subsequently, in April 2009, the Cabinet of Ministers passed the Resolution on Retail Bonds, providing for the issue of 12-month bonds with par value of UAH 500 and 16% coupon. The total amount of the issue is UAH 200 million and the bonds will be distributed through the State Savings Bank in the near future.

INCREASING TRANSPARENCY AND INFORMATION SUPPORT

The development of a viable domestic government market is impossible without the confidence of market participants; such confidence can be achieved only by means of transparency and good information support regarding all actions taken by the GOU. The issuance of domestic government bonds at market rates during pre-announced auctions in May 2009 provided an important opportunity to increase GOU transparency and information support. ATCI worked closely with the Ministry to ensure that information released about the new issues was comprehensive and applicable both for local and foreign investors. In particular, ATCI strongly recommended publishing not only the amount of bonds sold at an auction and a weighted average yield, but also the number and amounts of bids submitted and accepted, as well as the maximum and minimum yield levels. Toward this end, ATCI provided the MOF Sovereign Debt Department with a relevant template and beginning on 15June 2009, the MOF supplemented the auction results with the required information.

Once this new auction result format was available, and due in part to encouragement from ATCI, the Bloomberg international news agency started publishing Ukraine's bond issue results on its website. In August 2009, with ATCI assistance, auction results were made available in English on the MOF website. ATCI has regularly provided the Ministry with English versions of all regulations with regard to the development of the domestic government bond market in Ukraine; however, these have not been published on the MOF website to date.

Because of the delays in getting relevant information posted on the MOF website, ATCI decided to launch its own website (www.atci.com.ua) as a source of current information on Ukraine's government securities market. In June 2009, ATCI started publishing auction results, a yield curve of primary placements compared to average inter-bank deposit rates, as well as relevant legislative updates and their analysis; these items are available both in English and Ukrainian.

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Once complete information on the primary market became available to the public, the ATCI team focused on increasing the flow of information about secondary market activity. Because many market participants had remarked about the need for more price discovery on secondary trades, ATCI had discussions with the NBU in June 2009, and shortly afterwards the NBU began publishing information on secondary market trades on its website. However, the format used by the NBU provides only a general idea about the volumes; no bond codes or maturity dates are provided, which makes it impossible to calculate the yields and, therefore, to show the yield curve of the secondary market. ATCI continued to work with the NBU on supplementing this information, meeting again with NBU representatives in September 2009 to promote, among other things, the publication of more detailed information on the secondary trades in government securities.

CONTINUING THE DEVELOPMENT OF THE GOVERNMENT BOND MARKET: RECOMMENDATIONS

Throughout all its activities in developing the domestic government bond market, ATCI has kept various donor organizations and other donor-funded projects in Ukraine apprised of the up-to-date developments and successes with respect to the domestic government bond market. These organizations included the International Monetary Fund, the World Bank, the European Union project *Strengthening of Ukrainian Financial Services Sector*, United States Treasury Advisors, and the USAID-funded *Capital Markets Project*. ATCI is hopeful that the upcoming USAID FINREP project as well as other donor-funded interventions will continue to support the development of Ukraine's domestic government bond market. With this in mind, as of 1 October 2009, ATCI developed a series of key activities critical to future market development:

Primary Auctions: Continued monitoring of primary auctions to assure that the principles and procedures of single-stage, multi-price auctions are followed with respect to amounts awarded and bids accepted.

Primary Dealers: (1) Foster continued dialogue and cooperation between PDs and the MOF through regularly scheduled monthly meetings and the formation of joint committees to deal with settlements, trade practices, and issuance; and (2) re-introduce the concept of rights and obligations by mandating PDs as market makers, with trading agreements that specify bids and offer spread and trade size.

Secondary Markets: Continue to pursue the goal of transparent price discovery of all trades transacted in secondary market by lobbying the NBU to implement International Securities Identification Numbers (ISINs) to identify (1) particular issues traded and the yields at which they are traded, (2) holdings of OVDPs by categories with clear delineation of commercial banks, (3) primary dealers, and (4) state owned institutions

Repurchase/Reverse: Promote the adoption of a standardized master repo agreement for use by all parties (i.e., MOF, NBU, PDs, commercial banks, non-bank dealers, corporations, and municipalities).

Issuance and Management: Encourage the introduction of longer maturities and possibly new features (e.g., callables, sinking funds, step-ups) the goals of lengthening the average weighted maturity of debt securities, creating a representative longer-term yield curve, and establishing benchmark issues to aid the pricing of ancillary fixed-income instruments.

MUNICIPAL BONDS

Objective. Ukraine's cities need massive capital investments to modernize infrastructure. In late 2004, ATCI began working with selected cities to demonstrate how municipal bonds can help attract long-term capital in accordance with project goals and objectives (Table 1)

Indicators. As shown in Table 1, the target for this component was to assist two cities with the issuance of pilot municipal bonds.

Table 1. Summary of Project Results for Municipal Bonds Component

<table>
<tr><th>Overall Goal:</th><th colspan="6">To increase the volume of local investment in support of essential infrastructure and services</th></tr>
<tr><td>Result Statement
Issuance of pilot municipal bonds in Ukraine</td><td colspan="6">Bank lending is not available to municipalities for infrastructure improvement. Successful pilot bond issues have enabled:
Ivano-Frankivsk to install street lighting
Lviv to promote energy saving, the reconstruction of roads, utilities and street lighting
Lugansk to construct infrastructure, purchase technical equipment, reconstruct heating infrastructure, and install street lighting and landscaping along municipal streets
Berdyansk to reconstruct housing, roads, and install street lighting.
Four other small- or medium-sized cities have now issued bonds. More are preparing to do so. The "technology" of bond issuance is spreading among the target group of cities.</td></tr>
<tr><th colspan="7">Performance Measurement: Number of municipal bonds by first-time issuers</th></tr>
<tr><th>Indicator</th><th>Baseline/ 2004</th><th>2006</th><th>2007</th><th>June 2009 *</th><th>Sept 2009**</th><th>End-of-project target 2009</th></tr>
<tr><td>1. Number of cities issuing bonds with ATCI help.</td><td>0</td><td>1</td><td>4</td><td>2 (09/08)</td><td>2</td><td>2</td></tr>
<tr><td>Description</td><td></td><td>Ivano-Frankivsk issue UAH 5.5M bond</td><td>Lviv Series A UAH 50M
Series B UAH 42M
Lugansk UAH 29.3M
Berdyansk UAH 10M</td><td>Lviv Series C UAH 300M
Energodar UAH 10 M</td><td>Lviv Series C UAH 300M
Energodar UAH 10 M</td><td></td></tr>
</table>

*Bond issuances are in progress. City of Lviv approved the bond, got approval by the Ministry of Finance, registered at the SSMSC. City of Energodar is preparing documents for MOF approval and selection of an underwriter.

** City of Lviv received the first tranche of UAH 100M from Ukreximbank. City of Energodar is negotiating with potential underwriters (fixed underwriting)

Results. Through this component, ATCI provided assistance to four small- and medium-sized cities (populations less than 800,000) and enabled them to successfully access the municipal bond market, a cheaper and more efficient means for financing infrastructure, construction, and reconstruction projects than bank financing. ATCI also advised other cities on various aspects of bond issuance and municipal finance and worked to improve the legal and regulatory framework for local borrowing. It lobbied persistently, though unsuccessfully, for the creation of a pooled finance facility (municipal finance facility) that could provide small and medium-sized cities with additional funding sources.

Impact. The lives of the citizens of these municipalities were improved through the use of the proceeds of the bonds for road repairs, roof repairs for residential housing, improvements to street lighting, development and reconstruction of housing and municipal utilities, and other cities' needs. With ATCI assistance, the issues from these municipalities and others from cities that have used the ATCI bond issuance technology have precipitated an emerging asset class suitable for investment by pension funds and insurance companies. In or out of a financial crisis, ATCI expects that municipalities will continue to take advantage of competing markets to efficiently gain access to credit for improvements in the lives of Ukrainian citizens.

OVERCOMING CONSTRAINTS TO BOND ISSUANCE

In 1998, the City of Odessa defaulted on a $33 million bond issue; this had the effect of dampening investor enthusiasm for municipal bonds. Even so, municipal finance in Ukraine had a small revival in 2003–2004, just prior to the initiation of ATCI project activities. During this pre-ATCI period, three short- to-medium-term bond issues were placed; one by Kyiv, a special case; and one each by Zaporizhya and Donetsk. However, the initial optimism among donors over the 2001 amendments to the budgetary regulations governing intergovernmental transfers turned to skepticism. A key issue remained: because budgetary regulations still required muncipal funds to be held on account with the State Treasury, investors would not have unfettered access to those fund in the case of default.

ATCI began activities related to pilot municipal bond issuance in early 2005, focusing first on determining the creditworthiness of prospective cities or utilities and defining the responsibilities for the pilot issues.

Determining creditworthiness. In the Fall of 2005, long before the Budget Committee of the Verkhovna Rada (Parliament) took up amendments to simplify local borrowings in 2009, ATCI developed tools to analyze city and utility creditworthiness. Advisors applied the tools in a marketing campaign to select cities, with populations of 800,000 or less (in accordance with USAID directives), that were capable of bond issuance.

ATCI used data supplied by a counterpart, the Association of Ukrainian Cities (AUC), as well as by the USAID *Tariff Reform Project* (implemented by PADCO), to screen cities and utility companies for creditworthiness. ATCI contacted all utilities judged "financially viable" by PADCO and the State Committee of Ukraine on Housing and Communal Economy, and analyzed the companies that responded with financial data. ATCI later followed up with companies that did not respond. Altogether ATCI analyzed 20 utility companies for pilot bond issuance, including thorough evaluations of the data of 9 companies. As it turned out, no creditworthy utility companies were discovered.

ATCI received basic three-year financial data for all major cities from AUC. The data enabled ATCI to screen cities for creditworthiness before committing to meetings. After developing the financial screening tools, ATCI marketed its financial advisory services extensively to selected cities and utilities. The first city ATCI evaluated in detail with a bond capacity assessment was Komsomolsk. ATCI decided not to proceed with the city, given its small size and highly concentrated economy centered on a giant ore-processing plant.

Later, ATCI developed separate credit evaluation methodologies for communal service enterprises and cities. ATCI based its methodology on a model developed for cities in the Czech Republic by USAID and the Urban Institute. City data from Ivano-Frankivsk, Korosten, and Cherkasy were used as examples to test and develop the methodology. Altogether, ATCI produced and delivered bond capacity assessments for six cities: Komsomolsk, Korosten, Cherkasy, Ivano-Frankivsk, Berdyansk, and Lugansk; four of these actually issued pilot bonds. ATCI screened about ten additional cities in the process of seeking strong candidates that would warrant personal visits and in-depth evaluations.

Defining responsibilities. ATCI developed a detailed Protocol of Intention for Pilot Bond Cities that detailed the expected working relationship, goals, deliverables, and mutual responsibilities. Three stages of collaboration were spelled out in the Protocol: (1) bond capacity assessment, (2) development of the legal and financial structure of bond issue, and (3) city council approval and bond issuance. After face-to-face meetings, the Protocol was offered to cities and utilities whose financials had passed a detailed preliminary screening.

DEVELOPING PILOT MUNICIPAL BONDS FOR SMALLER CITIES

ATCI promoted the “technology” of bond issuance, as well as the fact that it has been successful in Eastern European countries such as Romania, as a public finance vehicle. The project also promoted a functioning credit bureau and the growth of secondary market trade that deepened credit markets and expanded the availability of capital. In all, ATCI directly assisted several smaller cities, with populations of 800,000 or less, in issuing primary bonds totaling UAH 137 million; this represented 12% of the total of all municipal issuances during the life of the Project (Figure 10). The relatively low percentage of total issuances represented by these pilot bonds is directly related to the size of the targeted cities; most of the municipal bonds are issued by larger cities such as Kyiv. Subsequently, a few of the pilot cities issued secondary bonds totaling UAH 350 million.

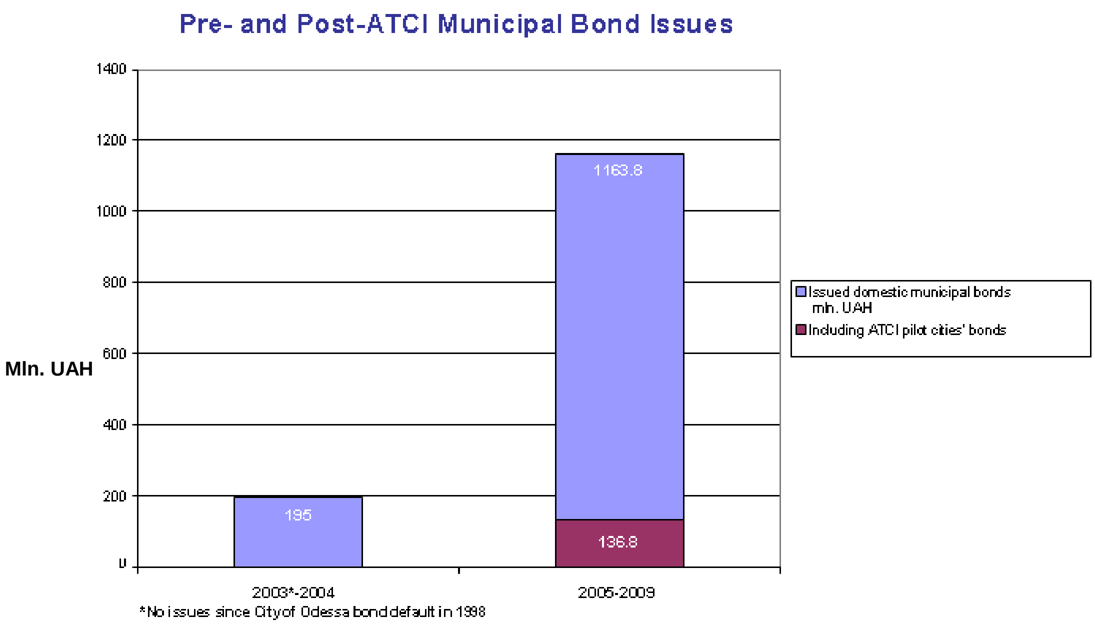

Figure 10. Municipal bond issues immediately prior to and during ATCI project

As described below, ATCI provided assistance to city councils of the four cities that issued pilot bonds. This included helping to determine the city’s investment priorities, preparing for and facilitating the credit rating for the city and the issue, structuring the issue, preparing the necessary documentation to obtain borrowing approval from the MOF, drafting tender documents and advising on the competitive process necessary to select an underwriter, and preparing the necessary documents to register the issue with the SSMSC (see *Attachment 8: Generic Bond Issue Timetable)*.

Berdyansk

In the Fall of 2005, Berdyansk (population 118,000) requested ATCI assistance with a bond issue. ATCI signed a Protocol of Intention with the city, and developed and presented a bond capacity assessment that advised the city to issue a UAH 10 million bond. ATCI agreed to provide technical assistance as well as financial support (to pay for the city’s credit rating).

Berdyansk held a tender for the credit rating agency with help from ATCI (i.e., initial documentation, contacts at three rating agencies) and selected Moody’s as its rating agency. ATCI advised on the development of the documents and information needed for the rating assessment and advised the city during the course of meetings between senior city management and Moody’s analysts. Berdyansk received a rating of B1 on the global scale and Aa3.ua on the national scale.

ATCI helped Berdyansk to prepare and submit its application for borrowing approval to the MOF. The application proposed an innovative credit enhancement structure that used put options. Following MOF approval, a press conference was held in Berdyansk with participation of the mayor, AUC, USAID, and ATCI. ATCI advised Berydansk on the underwriting tender; the winner was Alfa-bank with an 11.5% coupon bid**.** ATCI advised the city on its submission to SSMSC, providing it with the issue prospectus draft and some consultations.

Berdyansk's UAH 10 million bond was placed on 28 December 2007; it had a five-year term at 11.5% and was included in the PFTS exchange second tier listing. Proceeds from the bond were used for the development of Berydansk's main roads and residential housing reconstruction as well as for improved city lighting.

Ivano-Frankivsk

ATCI completed the Ivano-Frankivsk bond capacity assessment in August 2005. The assessment showed that the city (population 220,000) was capable of servicing more than seven times the contemplated UAH 5.5 million bond issue. ATCI notified the city that it appeared capable of issuance, and turned its attention to credit rating. USAID approved cash assistance to the city to pay for credit rating by an internationally recognized rating firm. The subsequent Standard & Poor's credit rating (B+ on the global scale, UaA on the national scale) added real value to the city's bond preparations, and also provided ATCI analysts with an international-standard for comparison of their own work. See *Attachment 9: Ivano-Frankivsk Investment Memorandum*.

In February 2006, Ivano-Frankivsk placed its first bond (this was also ATCI's first pilot bond). Ten banks competed to buy the bonds, resulting in favorable terms: five years, no put option, 12% interest, no fees paid by the city. The winning bidder was Kreschatik Bank. Bonds were listed for trading on the PFTS exchange, and bond proceeds were used for street lighting improvement.

In mid 2007, Ivano-Frankivsk approached ATCI with a request for advice on a second bond issue and the associated legal and financial issues. ATCI advised the city on the rating assessment of the issue and drafted the council resolution on the second bond issue. In September 2007, the city obtained a preliminary rating of B+/uaA for the five-year UAH 7.5 million issue from Standard and Poor's; however, it eventually decided to postpone the issue.

Lugansk

In mid-2006, the City of Lugansk (population 450,000) decided to collaborate with ATCI on its first municipal bond, targeted to be UAH 30 million. Following the signature of the Protocol of Intention, ATCI collected data and delivered the bond capacity assessment to the city. ATCI advised on obtaining an issue rating from Standard and Poor's and provided financial assistance for the rating. In December 2006, Standard and Poor's delivered ratings of B on the global scale and UaBBB+ on the national scale.

ATCI helped draft and submit the application for MOF borrowing approval for the UAH 29.3 million, five-year bond issue; MOF approval was given in July 2007. ATCI advised on the documentation package submitted for SSMSC registration and provided the city with the draft issue prospectus. Following submission of the documents to the SSMSC and bond registration, Ukrgazbank placed the municipal bond (Series A and B) on 5 November 2007 in the amount of UAH 29.3 million for five years at 10.4%, The bond was included in the PFTS exchange second-tier listing. Lugansk used the proceeds of the bond for construction, purchasing technical equipment, reconstruction of heating infrastructure, street lighting, and landscaping along city roads.

Lviv

Pilot bond issue. ATCI assisted Lviv (population 735,000) with its first bond issue (UAH 92 million), which was broken down into two series **:** a Series A bond of UAH 50 million and a Series B bond of UAH 42 million. The local council approved the borrowing in February 2007 with a maximum interest rate of 12%, and a maturity of up to five years. ATCI provided somewhat less intensive assistance to Lviv than it had for the other cities, as the ATCI pilot bond activity was being phased out at this point in time.

ATCI helped the city prepare data for a credit rating by Standard and Poor's (B+ on the global scale, UaA+ on the national scale) and assisted in preparation of the MOF documentation package, which secured MOF approval. In addition, ATCI assisted the city with development and submission of documents to the SSMSC for bond registration, advised on the documentation package, and provided the city with the draft issue prospectus. The Series A UAH 50 million issue was registered by the SSMSC and placed in July 2007. ATCI and the city conducted a joint press conference in September 2007 on the successful placement of Lviv Series A issue at 9.45%, the lowest rate in the history of Ukrainian domestic municipal placements to date.

Following the successful placement of Series A, the city requested ATCI assistance with drafting the supporting documentation to justify the second bond series issue of 42 million to the city council. ATCI drafted a supporting analytical note and in December 2007, VAB Bank, the underwriter and a payment services agent of the issue, placed series B of the municipal bond in the amount of UAH 42 million for five years at 9.95%. The Lviv UAH 92 million bond (i.e., both Series A and B) was included in the PFTS exchange second tier listing. The proceeds of the bond were used for energy saving, reconstruction of roads, utilities, and street lighting.

Subsequent bond issue. In 2008, the City of Lviv requested ATCI to assist with a UAH 200 million five-year bond issuance for financing the Euro 2012 Football Championship infrastructure. ATCI advised the city on the issuance schedule, debt limit, documentation for the MOF approval, bond structuring, and pricing. Following MOF approval, the city announced a competition for fixed underwriting with a maximum coupon rate of 12% (according to the city council resolution). ATCI advised on preparing the competition documentation. Given the low interest rate, the city received no bids. ATCI advised Lviv Deputy Mayor to reapply to the MOF for a higher maximum coupon rate and a lower issue volume of UAH 150 million. Due to political disagreements, the city was not able to follow this advice, but changed underwriting conditions from full commitment to best efforts. ATCI assisted the city in amending competition documents and monitoring current market interest rates and other cities' current and prospective placements. In October 2008, Lviv held another competition for underwriter selection and received one bid from the investment company Decra. The city consulted ATCI on local treasury vs. bank as a payment agent for the municipal bond issue, and on draft agreements with underwriter and payment agent. In December 2008, Lviv received no bids because the approved coupon rate was significantly below the market rate.

In 2009, Lviv again decided to issue a bond in preparation for the EURO-2012 Football Championship, this time for the amount of UAH 300 million. As requested, ATCI advised the city on the draft city council resolution regarding borrowing, current interest rates, and bond characteristics (i.e., registered/bearer bond, call option/no options). The city received an issue credit rating from Standard and Poor's (global B+, national UaA+) and submitted a request for approval to the MOF for the bond issuance. ATCI helped prepare tender documentation for an underwriter selection and of the issue prospectus. The city received approval from the MOF, selected an underwriter, registered the bond with SSMSC, and placed the first tranche of a UAH 100 million five-year maturity, 20% annual rate to Ukreximbank in June 2009. The remaining UAH 100 million is scheduled to be placed late in 2009 or 2010 to the same bank.

PROVIDING OTHER FINANCIAL ASSISTANCE TO MUNICIPALITIES

On an as-requested basis, ATCI provided assistance related to bond issues and municipal finance to cities not selected for pilot bond issues.

Specific Bond-related Assistance

In mid-2005, the City of Kharkiv was in the final stages of planning a UAH 100 million bond issue. The deputy mayor posed several legal questions to ATCI about MOF requirements for budget changes to accommodate the city's bond issuance, and our advisors responded with detailed guidance.

Other ATCI assistance was provided in the summer 2007 to the following cities:

- City of Lutsk: assistance with MOF submission, advised on tender, and provided tender documentation (i.e., fixed underwriting, coupon bids, costs borne by the underwriter) for a UAH 10 million bond (placed on 30 August 2007 at a 12% rate);
- City of Poltava: assistance with legal requirements of the issuance and draft city council resolution during the initial stage of bond issuance; and
- City of Chernivtsi, assistance with legal requirements of the issuance, financial aspects, and gaining a credit rating during the initial stage of bond issuance.

At the beginning of 2008, upon the cities' requests, ATCI advised Energodar and Melitopol on general legal and financial issues as well as a roadmap of municipal bond issuance. At the time, Energodar (pop. 54,000) was considering a UAH 10–20 million five-year bond for housing modernization and heating supply reconstruction, and Melitopol (pop. 160,000) was discussing a UAH 5–10 million, five-year bond for purchase and modernization of municipal transport. Later, Energodar formally requested ATCI technical assistance for a municipal bond issue for road reconstruction. Following signature of the Protocol of Intent, ATCI advised the city on the parameters of the issue (preliminary UAH 10 million, one year maturity), submitted the draft city council resolution on borrowing, and provided draft tender documentation for selection of an underwriter (e.g., fixed underwriting, coupon bids, costs borne by the underwriter). Also, Energodar requested ATCI to review and to advise on a draft European Bank for Reconstruction and Development (EBRD) loan agreement for a municipal heating and water-supply enterprise, given that the city will be a guarantor for the deal.

At the beginning of 2008, upon the cities' requests, ATCI advised Energodar and Melitopol on general legal and financial issues as well as a roadmap of municipal bond issuance.

The Odessa City Council intended to issue a UAH 300 million bond after receiving MOF approval for its placement in 2008. However, given the unfavorable market situation and the shortage of time, the council decided to postpone the placement to 2009. ATCI assisted in preparing the relevant draft documents including the city council resolution stipulating the budget deficit for development for 2009 and a letter to MOF for re-approval of the issue**.**

General Financial Assistance

Ukrainian municipalities often have treasury balances available for liquidity management purposes. On 28 January 2009, the Cabinet of Ministers adopted Resolution 52 "On Approval of the Procedure for Placement in 2009 of Temporarily Free Funds of Local Budgets in Deposit Accounts in the Banking Institutions," which obliges municipalities to place their treasury balances exclusively in state-owned banks. The likely reason for limiting the circle of approved banks was the fear that these funds would be lost because of possible insolvency of banks resulting from the financial crisis. For example, as of 1 March 2009, UAH 400 million had not be repaid to cities by commercial banks even though the time deposits for these funds had expired. Because of such situations, ATCI began an initiative for pilot municipal repo transactions with domestic government bonds and municipal bonds as provided by Article 18 of the law "On State Budget of Ukraine for 2009".

To help municipalities earn interest, more efficiently manage treasury balances, and minimize credit risk, ATCI suggested to the Cabinet of Ministers in 2008 that cities be allowed to place excess balances with banks in deposits secured by collateral of government bonds or the same city's municipal bonds. In 2009, after amendments to the budget law, cities were allowed to carry out reverse repos of government or their own municipal bonds with banks. ATCI entered into discussion with Odessa and Energodar as possible pilot cities for this initiative. At the cities' requests, ATCI developed a set of draft documents for implementing these transactions; the documentation includes the scheme of the transaction, city council resolution, deposit agreement, pledge agreement, procedure on repo transaction to be approved by the city council, repo agreement, and a letter to the State Treasury for clarification of bonds' accounting by cities. This process will demonstrate an additional use of municipal bonds as a financing mechanism, resulting in additional incentives for municipal issuance.

CONTRIBUTING TO LEGAL AND REGULATORY FRAMEWORK FOR LOCAL BORROWING

Beginning in 2005, ATCI worked with the MOF on a revived draft law on local borrowing. The 30 June 2005 draft was control-oriented, increasing MOF scrutiny of local borrowings and guarantees, but doing little to facilitate municipal access to capital markets. The ATCI legal consultant provided detailed comments on the law and, in August 2005, presented these findings to an interministerial audience of 40 participants in Kyiv.

In April 2006, ATCI participated in the MOF roundtable discussion of the proposed law on local borrowing and local guarantees. USAID/ATCI was the only donor organization present at the 3½-hour working meeting, which included representatives from the SSMSC, Ministry of Economy, Ministry of Construction, and the deputy mayor and chief financial officer of Kyiv. ATCI delivered detailed policy and technical comments on the draft law. Later in 2006, ATCI participated in six meetings of the MOF working group on the proposed law on local borrowing and local guarantees; ATCI provided legal recommendations for establishing a municipal finance facility, including proposals to improve the legal framework for local borrowing. In the end, the group produced recommended amendments to the budget code instead of a stand-alone comprehensive law on local borrowing and relatively few of the ATCI recommendations were included in the Ministry's proposed amendments. The amendments were circulated for comment from other ministries.

In April 2006, ATCI participated in the MOF roundtable discussion of the proposed law on local borrowing and local guarantees. USAID/ATCI was the only donor organization present at the 3½-hour working meeting, which included representatives from the SSMSC, Ministry of Economy, Ministry of Construction, and the deputy mayor and chief financial officer of Kyiv.

In September 2008, ATCI completed a study of municipal creditworthiness for the period 2004–2007, using the AUC publication *Financial Performance of Cities* as a basis for the research. The aim of the study was to determine whether creditworthiness had increased for Ukrainian cities since ATCI began its screening and pilot issues. The analysis of a sample of 73 cities during 2004–2007 showed a general positive trend in the creditworthiness of the cities, indicating a better possibility for successful bond issuance and placement. See *Attachment 10: Impact of Fiscal Changes on Cities' Creditworthiness*.

In the beginning of 2009, the Budget Committee of the Verkhovna Rada prepared draft amendments to the budget code for the second reading. ATCI developed proposals to the draft amendments which were aimed to simplify local borrowings within the crisis environment; specifically:

- To define debt management;
- To cancel the prohibition against external borrowing by cities;
- To determine the territorial communities of cities and the Autonomous Republic of Crimea as the borrowers and guarantors;
- To introduce the possibility of intercepting local budget funds, within the limits of the development budget proceeds, in the case of non-fulfillment of liabilities by the borrower or guarantor;
- To restrict local government participation in local companies to companies involved in communities services (utilities) only;
- To provide for the possibility that local government in the Autonomous Republic of Crimea can extend credits to local utilities;
- To limit prohibitions resulting from the violation of a payment schedule to new borrowings, and to preserve the right to borrow for debt refinancing purposes; and
- To define "contingent debt" and to regulate obligations undertaken by state and local territorial communities under public-private partnership, etc.

The new version of the budget code was adopted by the Verkhovna Rada on 23 June 2009, but was subsequently vetoed by the President.

In cooperation with the USAID-funded Institute for Budgetary and Socio-Economic Research (IBSER) project and the AUC, ATCI developed amendments to the Cabinet of Ministers Regulation 207 "On

Procedure of Local Borrowing" in order to simplify borrowings and make them less expensive. On 17 August 2009, the Cabinet of Ministers adopted Resolution 865 amending the Procedure of Local Borrowing. In particular, Cabinet of Ministers approved the following ATCI recommended amendments:

- If the placement of municipal bonds is public and takes place on stock exchanges, municipalities are allowed to sell their bonds not only at par value, but below or even above par;
- A credit rating is no longer needed for loans (unfortunately, it is still necessary for bond issuance);
- Debt limits are set forth for municipalities as well as grounds for objection to their borrowing by the MOF;
- To assess compliance with the set requirements, floating and exchange rates are fixed at the level of the day previous to that on which the relevant documents are submitted to the MOF;
- With regard to assessing compliance with the requirements for borrowing from international financial institutions, only 25% of direct and guaranteed debt expenses are taken into account;
- Maximum levels of borrowing, which do not need to be agreed upon with the MOF, are stipulated; and
- If the MOF does not provide objections to a municipality's draft resolution on local borrowing within 30 days, such resolution is considered to be in compliance with budget law in force.

LOBBYING FOR A POOLED FINANCE FACILITY (MUNICIPAL FINANCE FACILITY)

The need for investment in the housing and utilities economy and infrastructure of Ukrainian cities is immense and urgent. Local budgets simply are not sufficient and private companies do not invest in municipal projects because these projects have a long payback period and numerous risks associated with insufficient creditworthiness of communal enterprises (e.g., unresolved tariffs).

One of the most effective methods to finance municipal projects in small- and medium-sized cities is to establish a financial institution—commonly referred to as a municipal finance facility—that can borrow on its own behalf without sovereign guarantees and can lend to creditworthy cities and communal enterprises at the lowest possible market interest rates (due to economies of scale). Municipal finance facilities (MFFs) (that may operate successfully as profitable businesses) operate in many countries with different economies and cultures, including Canada, the Czech Republic, the US, South Africa, the Philippines, India, and Western European countries.

EFFORTS TO DEVELOP INTEREST IN ESTABLISHING AN MFF

In January 2006, ATCI held a conference on creating an MFF featuring nine experts from Russia, Sweden, Finland, South Africa, Canada, and the US. The conference attracted top-level government interest, resulting in the formation of a task force composed of senior officials from three ministries. ATCI delivered an analysis of ownership options for the new facility, and added recommendations for immediate- and medium-term action steps to create an MFF.

ATCI took steps to institutionalize the task force in view of the coming change in government following the March 2006 elections. The Minister of Construction and Housing Economy issued an Executive Order creating the Task Force on an MFF. In addition, the Minister secured a Cabinet of Ministers' Decree approving the creation of an MFF as a priority initiative. ATCI made a detailed presentation of strategic options for MFF development in late July 2006. ATCI organized meetings with senior officials of the new government in an effort to maintain momentum for creation of an MFF. The First Deputy Minister of Economy and the Deputy Construction Minister received a detailed briefing in September 2006 and expressed strong support. A short-term ATCI advisor assisted with a presentation to the MOF that was attended by the Deputy Finance Minister, Deputy Construction Minister, AUC Director; Director of MOF Office of Public Debt, and representatives from commercial banks.

At the beginning of 2007, USAID initiated another drive to get top-level GOU support for the creation of an MFF. In March 2007, USAID and ATCI presented an MFF concept at a meeting chaired by an advisor to Prime Minister, representatives of the Secretariat of the Cabinet of Ministers and other ministries. Following the meeting, an order establishing an MFF working group was signed by Vice Prime

Minister. The working group, headed by the MOF, also included representatives of the Ministry of Regional Development and Construction, Ministry of Economy, FSR, SSMSC, AUC, ATCI, and city mayors. The group developed proposals on the MFF issue for presentation to the Cabinet of Ministers.

Subsequently ATCI held a series of meetings with AUC and the USAID-funded Commercial Law Center regarding establishment of an MFF and the associated legal and financial issues. In June 2007, the ATCI presented the MFF concept to the working group chaired by the MOF Deputy Finance Minister. A Cabinet of Ministers' resolution on MFF creation, drafted in collaboration with the CLC, as well as a draft MFF charter was submitted to the working group. Following the ATCI presentation, the MOF developed an analytical note that postponed MFF establishment. ATCI continued, nevertheless, to conduct meetings with the AUC regarding the strategy of MFF establishment and the associated legal and financial issues, and AUC filed another request to Cabinet of Ministers to establish a working group on MFF development.

During 2007 and 2008, ATCI discussed private financing with both individuals and groups, and discussed financing for MFF development with other ministries and donors or investors such as the IMF, KfW (a German development bank), the ITT Investment Group, and EBRD. There appeared to be no interest in MFF development, and the concept remains unrealized. However, ATCI presented the MFF concept to an interministerial meeting on Euro-2012 preparation chaired by Minister of Economy and following the meeting, the MFF concept was included in the measures for implementing a national program in preparation for the Euro 2012 Football Championship in Ukraine. In line with these measures, ATCI provided comments to the draft law "On Creating Organizational and Legal Framework to Attract Investments for Preparing and Conducting the Final Stage of the Euro 2012 Football Championship in Ukraine." These comments established the legal grounds for creating the MFF as an investment project by way of (1) directing funds from the state budget under the state budget law for the corresponding year, and (2) regulating the implementation of investment projects by economic entities.

In addition, ATCI met with USAID and the State Agency for Investments and Innovations (SAII). SAII indicated that the national program "Creation of Innovation Infrastructure in Ukraine in 2009-20013" (approved by the Cabinet of Ministers Decree No 447 of 14 May 2008) provides for the creation of regional communal special non-banking innovative finance and credit institutions (i.e., regional MFF-like institutions), at the expense of local budgets. No central budget investments are available. USAID and ATCI recommended that SAII discuss this concept with AUC, after which the three parties could meet again and discuss possible further joint efforts.

Following the meeting, the SAII officially submitted a letter to the MOF supporting and justifying the creation of an MFF. The MOF responded by letter stating that it is not advisable to form an MFF from the State Budget funds statutory capital of the institution that lend to the regional projects for modernization of communal structures.

DEVELOPMENT OF LEGISLATIVE BASIS FOR AN MFF

Because of the difficulty in identifying a committed counterpart willing to champion the establishment of an MFF, in early 2008, USAID tasked ATCI with focusing instead on developing an enabling environment for the successful establishment of an MFF. In response, ATCI prepared a draft law on local borrowing and local, which also includes a section on the establishment and functioning of an MFF. The draft law was intended to eliminate existing legal obstacles to local borrowing and guarantees as well as to ensure the creation of an MFF and effective activities. Obligations constituting municipal debt include an important component of so-called contingent liabilities; these cease to be contingent upon the occurrence of specific future events such as the non-fulfillment of guarantee obligations by the borrower (a guarantee case) or a private partner's fulfillment of its obligations under an agreement of public-private partnership. Under such circumstances, the draft law aimed to regulate the issue of

Because of the difficulty in identifying a committed counterpart willing to champion the establishment of an MFF, in early 2008, USAID tasked ATCI with focusing instead on developing an enabling environment for the successful establishment of an MFF.

including obligations to a private partner as well as municipal debt**.** ATCI introduced relevant budget code amendments, including the introduction of definitions for contingent liabilities and contingent debt and the regulation of obligations undertaken by local communities through public-private partnership. The draft was submitted to the AUC for consideration and further discussion.

Meanwhile, another draft Law amending the economic code and the law on business partnerships was passed, allowing budgetary funds to be invested in specific business partnerships envisaged by the law. This means that if the government decides to invest in an MFF, it can add the relevant provision in a law (e.g., the law on local borrowings or the budget law for the relevant year). ATCI had promoted the elimination of this ban on prior occasions, but it remained one of main objections from the MOF.

In late 2008, after reviewing the lack of progress and interest in the development of the MFF, USAID approved the removal of all MFF activities within the ATCI work plan, with the exception of further development of the legislative basis for the MFF.

TRANSFERRING THE METHODOLOGY FOR MUNICIPAL BOND ISSUANCE

After effectively completing its work on pilot bond issuance, ATCI began to concentrate on working with the AUC to arrange workshops for transferring the successful pilot methodology for bond issuance to other cities. ATCI delivered four workshops on the financial and legal aspects of municipal bond issuance process, as follows:

- City of Zhytomyr in April 2007 (in collaboration with Zhytomyr State Oblast Administration);
- City of Lviv in April 2007;
- City of Alchevsk in September 2007 (as part of the general USAID presentation); and
- The Fourth Ukrainian Municipal Forum in Artek (Crimea), October 2008 (The ATCI presentation "Municipal Borrowings as an Important Means of City Development Financing" was published in the handbook of the Forum.)

The audiences for these workshops included mayors, deputy mayors, deputies of city councils, heads of financial departments, and other senior city officials. Following the workshops, the cities of Lutsk, Poltava, and Chernivtsi requested advice from ATCI regarding the bond issuance processes.

In March 2009, ATCI attended the All-Ukrainian Municipal Hearings, conducted by the Fund of Ukraine's Local Governance Promotion and the AUC, with the participation of the President, members of Parliament, ministers, local governments, and city mayors. ATCI participated in the session on financial, economic, legal, and institutional reforms related to local governance. In April 2009, ATCI participated in the roundtable *Partnership Between Banks and Municipalities as One of the Ways to Fight Economic Crisis*. As mentioned earlier, ATCI recommendations on placement of municipal bonds below par and the elimination of mandatory credit ratings were included into the roundtable discussion.

CONTINUING DEVELOPMENT OF MUNICIPAL FINANCE: RECOMMENDATIONS

1. ATCI, along with the AUC has drafted and updated the Draft Law on Sub National Borrowings. Amendments were incorporated from comments made by and received from cities. This final version is left with the AUC to present to Parliament. This Law, however, must be in compliance with the (vetoed) Budget Code. After the Budget Code is adopted, the AUC must make required amendments before submission.

2. The MFF concept, along with ATCI documents for strategies of implementation and operation, could be picked up again, and peddled to various donor organizations or for private financing.

FINANCIAL LEASING

Objective. The primary goals of the Financial Leasing Component were to create a supportive environment for modern financial leasing and provide specific technical advisory and training assistance in order to increase access to credit throughout Ukraine. The two major activities implemented to attain these goals were (1) conducting the Certified Leasing Specialist (CLS) program and (2) providing domestic and international advisory services to both local lessors and foreign investor groups interested in entering the Ukrainian Financial Leasing Market.

Indicators and results. Table 2 summarizes the results of project activities according to established indicators.

Table 2. Summary of Project Results for Financial Leasing Component

Overall Goal	**Create a supportive environment for modern financial leasing and provide specific technical advisory and training assistance in order to increase access to credit throughout Ukraine**					
Result Statement *Build Capacity of Market Participants*	**Narrative Analysis:** Development of Certified Leasing Specialists (CLS) and establishment of the Ukrainian Society of Certified Leasing Specialists (USCLS) will address the shortage of leasing professionals and increase the capacity of the industry to grow. * Leasing Penetration Rate is calculated by dividing the amount of overall **new** leasing business (provided by FSR) by investment in fixed assets excluding investment in private dwellings (provided by State Statistics Committee). **NOTE: due to financial and economic crises, numbers are down in 2008/2009.**					
Performance Measurement: Establish a Certified Leasing Specialist (CLS) Program in Ukraine.						
Indicator	**Baseline / 2004**	**2006**	**2007**	**2008**	**Sept 2009**	**End-of-project target 2009**
1. Total number of certified leasing specialists (CLS)	0	16 (as of 9/06)	67	95	104	50
2. Number of leasing companies employing CLS	0	7	22	28	30	20
3. Annual volume of **new** leases (million USD)	165	270	**2300**	1300	202 (as of 06/09)	1350
4. Leasing penetration rate (% of all investment in fixed assets financed through leasing)	Less than 1%	1.5%	**7.7%**	4.1%	3.1% (as of 06/09)	6%

Impact. Leasing is non-mortgage product-specific finance. Like the increase in outstanding mortgages, Ukraine's lease penetration rate increased almost eightfold during the course of the project, meaning there was about eight times greater access to credit via leasing in Ukraine in 2008 than there was before ATCI began. Also like the mortgage market, the leasing market was dealt a serious blow by the financial crisis. Ukrainian leasing companies owned by foreign banks accounted for 40% of leasing volume in 2008.

Activities. The CLS program awards certificates to individuals who pass a set of three exams, and is designed to raise the stature of those who work in the financial leasing industry as well as to ensure that a pool of qualified candidates is available to help accelerate the growth of the industry in Ukraine. Advisory services are designed to broaden the capacity of companies already in the market, as well as to assist companies entering the market, either as operating leasing companies or as outside investors or suppliers.

BUILDING CAPACITY

The Leasing Component activities were initiated in early 2005; an assessment of the legal, tax, and regulatory environment identified significant barriers to the development of Ukraine's leasing industry and presented strategies to eliminate or mitigate those barriers. ATCI technical advisors met with major leasing companies and established working relationships with the Ukrleasing Association, other technical assistance projects with leasing components(IFC, CNFA), and government bodies (in particular, the FSR) with whom the project would work to refine the recommendations and implement necessary reforms.

Changes to Ukraine's tax code passed in late March 2005 negatively affected leasing operations; consequently, ATCI launched a new activity aimed at creating a more favorable legal and tax environment for the leasing industry in Ukraine. ATCI worked with various leasing stakeholders to present recommendations to the Cabinet of Ministers and the FSR related to the: (1) elimination of conflicting definitions and legal treatment of leasing in Ukraine's commercial code, relative to the civil code and law on financial leasing; (2) elimination of unequal tax treatment of leasing versus comparable forms of financing; and (3) introduction of accelerated depreciation of equipment for tax purposes.

ATCI encouraged the Ministry of Economy to initiate the *Government Program for the Development of the Leasing Industry for 2006-2010*. ATCI was included in the working group under the Cabinet of Ministers to develop this document and present it for approval at the Cabinet of Ministers level. ATCI also provided a series of proposals to the MOF on tax policies that had been effective in facilitating the growth of the leasing industry and investment in fixed assets in other countries. In 2009, ATCI was asked to provide its comments to Ukraine's *Government Strategy of Financial Sector Development*, a document aimed at ensuring the sustainability, transparency, and competitiveness of the Ukrainian financial sector, and in particular, of the leasing market, which was named one of the priority financial markets. ATCI emphasized the need for the elimination of inconsistencies among various legal acts regulating the leasing business, the use of taxes to stimulate the development of leasing as means of fixed assets acquisition, and better access by leasing companies to long-term financing.

As part of its capacity-building activities, ATCI provided technical assistance in the establishment of a new leasing association—the Ukrainian Union of Lessors (UUL). Particular assistance was provided with regard to developing the charter and defining the goals and objectives of the organization based on the needs of the leasing industry. One of these goals, for example, was that ATCI would assist the UUL in becoming a member of LeasEurope, a consortium of leasing associations from 27 European countries; this goal was achieved in **2006**. ATCI also worked with the UUL to develop an informational CD on Ukraine's leasing industry that was distributed to participants of the LeasEurope International Leasing Conference in March 2007 to attract the interest of European lessors and banks in the Ukrainian industry. At present, the UUL has 21 members representing more than 60% of the Ukrainian leasing market.

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Certified Lease Specialist Program

ATCI, in partnership with the Ukrleasing Association and the U.S.-based Certified Leasing Professionals Foundation (CLPF), launched the Certified Leasing Specialist (CLS) program to enable Ukraine leasing market participants to attain world standards of practice. A strong demand among lessors for a training program was confirmed by the 26 leasing companies that participated in the working group set up by ATCI to develop the training course in October 2005. ATCI engaged a board member of the US-based CLPF to assist in developing a CLS program for Ukraine and capacity-building seminars for Ukrainian industry participants.

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The US-developed course was adapted for the Ukrainian environment, particularly with respect to taxation, legislation, and accounting practices (the Ukrainian CLS program was later adapted and implemented in the ATCI Moldova project during 2006–2009) Working with lessors, ATCI determined that the optimal format for the training program consisted of 13 training topics split into three modules. Topics cover the essential aspects of leasing business such as the legal framework, accounting and tax treatment, credit analysis, leasing company management, and work with founding sources. See *Attachment 11: CLS Course Curriculum*.

The first training session, conducted by ATCI in July–September 2006, aimed not to raise the professional level of participants but also to prepare them to serve as trainers for subsequent CLS candidates (i.e., training of trainers). Of the total of 40 participants, 26 passed all three qualification exams and received CLS certificates, and 10 of these became CLS trainers. These trainers included two senior managers of the auditing and consulting company Kompas, which was authorized by ATCI to become an official training provider of the CLS program in Ukraine in January 2007. All subsequent training sessions were conducted by Kompas on a commercial basis with ATCI assisting with the preparation of training materials.

During 2006–2009, over 250 individuals, or nearly 13% of all those employed in leasing in Ukraine, undertook training within the CLS program (Figure 11). By the end of the ATCI project, 104 people were certified including the top managers and leading specialists of 30 Ukrainian leasing companies.

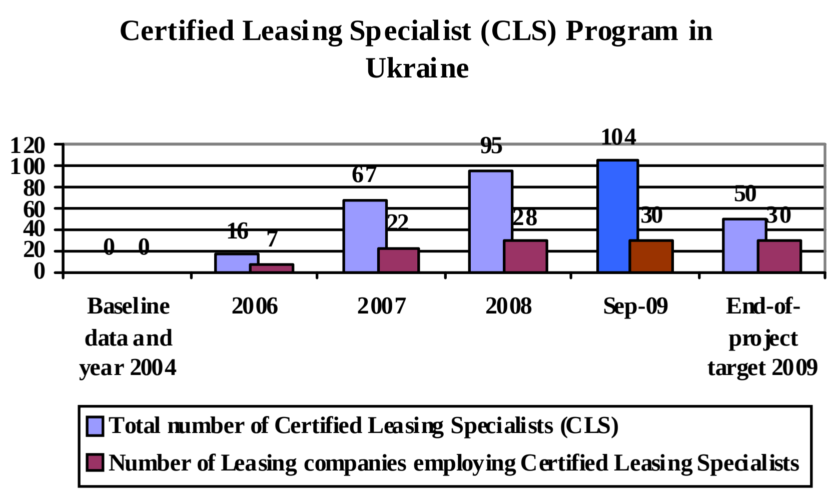

Figure 11. Participants in the Certified Leasing Specialist program in Ukraine

In February 2007, ATCI established a nongovernmental organization (NGO), the Certified Lease Specialist Union, to maintain CLS standards and unite all CLS under one roof. The Union's objectives included coordinating training sessions, maintaining the professional ethics and standards of certified specialists, developing topics for professional development of its members and non-members, and managing CLS program training and exam content. Under the aegis of the NGO, training providers offered CLS courses paid for by individuals seeking to achieve the status of a CLS. As of September 2009, the NGO had 53 active members and was on the way to long-term sustainability.

In February 2007, ATCI established a nongovernmental organization (NGO), the Certified Lease Specialist Union, to maintain CLS standards and unite all CLS under one roof.

As part of its public awareness and outreach campaign, ATCI developed a website for the NGO and created a newsletter for leasing professionals. Those tools provide useful information, not only about the CLS program and the Certified Lease

Specialist Union, but about every aspect of the leasing business in Ukraine. In particular, the website contains a knowledge base that can be used by leasing specialists (free of charge by Union members and for a set fee by non-members) to continue their professional development. In 2009, ATCI paid for the licensing agreement with CLPF to be transferred to the Union so it can continue to provide CLS training and certification in Ukraine.

The CLS program has also helped institutes of higher education develop leasing curricula. In June 2009, members of the Certified Lease Specialist Union were invited by the Chair of Banking, Kyiv National University for Trade and Economics, to take part in the development of master's program in leasing. These activities included designing a leasing curriculum and choosing topics for diploma theses.

INFORMATION CAMPAIGN

In April 2005, ATCI kicked off a public awareness campaign with a conference titled *Leasing in Ukraine – The Path to Development*. The conference presented the benefits of leasing and the necessary steps for the development of Ukraine's leasing industry. Attended by over 40 representatives of leasing companies, relevant government institutions, and mass media, the conference provided participants with an overview of Ukraine's current leasing industry, critical elements needed for the industry's growth, and planned activities to facilitate the development of leasing in Ukraine.

ATCI also held specialized seminars for leasing companies touching upon specific areas of the industry. For instance, in July 2005, ATCI developed and delivered a one-day training seminar on *Risk Management* for 28 managers of leasing companies. The training focused on credit analysis, financial management, and deal structuring. Since low capitalization and the lack of investment in leasing companies was a main factor restricting the industry's growth, the adoption of international best practices related to risk management by Ukrainian leasing companies was a prelude to being able to access investment and debt financing, especially from foreign financial institutions.

A series of seminars on leasing practices in Ukraine was held by ATCI in cooperation with the Ukrainian League of Industrials and Entrepreneurs. These seminars targeted enterprises searching for financing options to acquire capital assets for business modernization and development as well as producers/sellers of equipment interested in the development of their marketing and sales policy. Seminars were held in Kyiv (June 2005), Odessa (September 2005), Lviv (October 2005), Simferopol (June 2007), and Donetsk (March 2008).

Outreach campaigns in various regions of Ukraine were reinforced by ATCI collaboration with the IFC Leasing Development Project to co-sponsor a series of seminars directed at lessees, local government officials, and the local media. These seminars were held in Chernivtsi (March 2007), Chernigiv (April 2007), Ternopil (April 2007), and Sumy (May 2007).

At the international level, ATCI was one of four sponsors of the LeasEurope Conference held on 27–28 March 2007; this was the first international leasing conference ever to be held in Ukraine. Over 140 delegates attended, including many from international banks and other financial institutions, some of which were considering setting up operations in Ukraine. The conference was hosted by the UUL, had become a member of LeasEurope with ATCI assistance. The participants discussed emerging trends, challenges, and opportunities in the leasing market and how these would impact the business. Special focus was placed on practical solutions and experiences. ATCI also supported the participation of Moldovan lessors in the conference.

In August 2008, ATCI was invited to become a permanent member of the Leasing Commission that was being set up within the Ukrainian League of Industrialists and Entrepreneurs. The scope of work of the Commission was to review leasing-related legislation; prepare legal documents aimed at improvement of leasing environment in Ukraine; resolve conflicts which involve members of the League working in leasing; review and examine governmental programs and projects in the field of leasing; and improve the

In August 2008, ATCI was invited to become a permanent member of the Leasing Commission that was being set up within the Ukrainian League of Industrialists and Entrepreneurs.

professional training of leasing specialists. ATCI suggested holding educational seminars for public officers of the Commission to raise their awareness about leasing and the regulatory reforms needed for the Ukrainian economy to benefit most from this financial tool. A seminar was held for this purpose on 28 May 2009, and was attended by representatives of the ministries of economy, finance, and justice; Verkhovna Rada committees on tax and customs, and economic and agrarian policy; the NBU; the State Tax Administration, and others. Representatives of the Verkhovna Rada Committee on Taxation and Customs expressed their intent to engage ATCI experts to help elaborate relevant amendments to tax laws that would eliminate current inconsistencies and create a more favorable environment for the development of leasing in Ukraine.

At the end of 2008, the focus of ATCI public awareness activities shifted from expanding knowledge about leasing to finding ways to alleviate the adverse effects of the financial and economic crises on the industry. On 18 December 2008, ATCI co-sponsored the leasing roundtable *Leasing Companies' Operations Against the Background of the Unstable Financial Market*. The event addressed the issues of the monetary and credit policy of the NBU amidst the financial crisis, possible after-effects for the leasing industry, anti-crisis tools for leasing companies, and possible capital market development trends.

LEASING MANUAL

In 2007, ATCI began drafting a leasing manual to increase general awareness about leasing and raise the professional level of market participants. At this time, the only reference materials about leasing were either Russian or translated versions of foreign works that did not reflect the peculiar features of the leasing business and environment in Ukraine. To develop a useful leasing manual, ATCI set up a working group of eight top managers of Ukrainian leasing companies, all of whom were CLS. The working group developed a detailed plan of the manual based on scopes of work for each author; subsequently, each chapter was reviewed and commented on by all the authors, and a final review was made by the ATCI Leasing Advisor. See *Attachment 12: Leasing Manual Outline*.

The *Leasing Manual* was published in June 2009, with the official presentation taking place on 8 July. The manual was the first comprehensive study of the macro- and microeconomic aspects of the leasing business in Ukraine; it also compared Ukrainian leasing practices best international practices in this field. It was designed to be used by employees of leasing companies who could benefit from the practical experience of its authors, as well as by higher educational establishments as the basis for curricula on leasing. A total of 53 higher educational establishments throughout Ukraine obtained free copies of the manual provided by ATCI; beginning in September 2009, the *Leasing Manual* was used extensively by universities in Kyiv, Kharkiv, Lviv, Sumy, and Donetsk. Kyiv National University for Trade and Economics has already started developing topics for master's theses in leasing based on the manual. The *Leasing Manual* also complements the CLS training and contributes to the sustainability of the Certified Lease Specialist Union which is now responsible for the CLS training.

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RESEARCHING THE MARKET

ATCI analyzed existing fragmentary data provided by various governmental agencies regarding the leasing industry, and supplemented this data with its own surveys of the market to produce a comprehensive industry picture.

Market surveys. To plan activities and assess their impact, it was essential for ATCI to have a clear view of the development of the leasing market in Ukraine. Toward this end, a system of indicators reflecting the macro situation in the leasing market was developed.

The first analyzed measure was the leasing *penetration rate,* a widely used concept in Europe and throughout the world, but virtually

The increased use of leasing as a means to finance capital equipment was a major objective of ATCI; as shown in Table 2, this rate increased significantly (from less than 1% in 2004 to 7.7% in 2007) during the initial years of the project; it has since fallen somewhat due to the recent economic and financial crisis.

unknown in Ukraine at that time. The penetration rate, which shows the extent to which the financial leasing is used as a method of acquiring capital equipment, was calculated according to the LeasEurope approach: the amount of overall new leases divided by gross fixed capital formation excluding investment in private dwelling. The increased use of leasing as a means to finance capital equipment was a major objective of ATCI; as shown in Table 2, this rate increased significantly (from less than 1% in 2004 to 7.7% in 2007) during the initial years of the project; it has since fallen somewhat due to the recent economic and financial crisis. Given the growth in some of the leasing companies that were advised by the project, ATCI can take direct credit for a certain amount of increase in the leasing penetration rate. Other indicators included the volume of new leases, lease portfolio size and structure, number of employees, sources of financing, and owners of leasing companies (i.e. bank, supplier or a company is an independent one).

ATCI drafted a questionnaire that was distributed among the leasing companies to obtain the necessary information about these indicators. Prior to May 2008, when the IFC Leasing Development project came to a close, this type of market research was conducted by IFC with input from ATCI. After this date, ATCI joined efforts with the UUL to ensure that the market research was effective and accurate. The UUL obtained methodological guidelines and databases from the IFC project and the FSR and supplemented FSR's compulsory questionnaire with items, which were of interest for ATCI and the UUL. In March 2009, the findings of the 2008 leasing survey were presented. These findings showed a 40% drop in new leases as compared to 2007 because of the financial crisis. ATCI continued to work with the FSR and UUL to ensure that market participants were provided with results of such surveys on a quarterly basis.

Surveys of foreign-owned leasing companies. *Foreign* inputs are the most efficient way to build leasing capacity quickly; thus, the assessment of the share of foreign capital in the Ukrainian leasing market and monitoring of its dynamics with respect to importing capital and international expertise is an important indicator. To learn more about this market share, ATCI delivered short questionnaires to leasing companies owned by foreign banks, asking them to provide information on the amounts of new leases, as well as the size and structure of their leasing portfolios. An analysis of survey results indicated that, thanks to their better access to financing, the portfolios of leasing companies owned by foreign banks were constantly increasing (by 100% per year, on average) and the number of new leases increased by 150% per year, on average. Thus, leasing affiliates of foreign banks had boosted their market share to 40% by 2008.

PROVIDING CONSULTING SERVICES

ATCI provided consulting and advisory services focused on three main types of activities: (1) assisting leasing companies to access financing sources including equity financing, credit lines, and post-import financing from agencies such as the U.S. ExIm Bank and analogous organizations in other countries; (2) establishing relationships with equipment vendors and developing financial products tailored to the needs of these vendors' customers; and (3) ad hoc advisory services on tax, legal, and credit issues, typically on a transactional basis. Figure 12 indicates the growth in the number of active lessors during the period from 2004–2009; the decrease in the number of active, registered leasing companies during 2009 reflects the impact of the financial crisis on the industry.

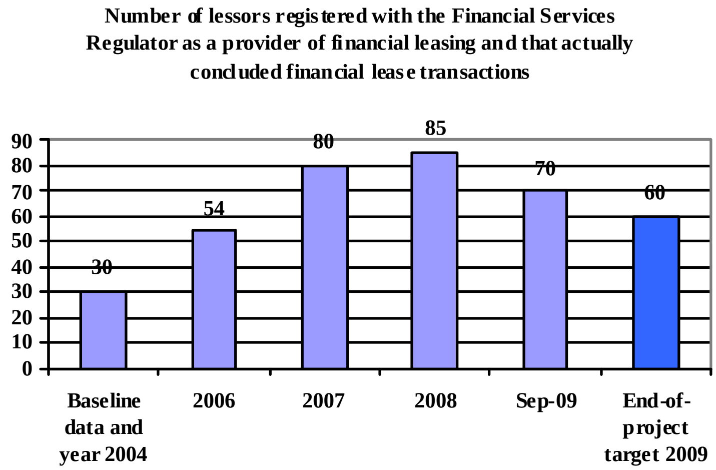

Figure 12. Number of registered lessors that actually concluded financial lease transactions

The objective of ATCI's advisory services was to focus on companies who, in the opinion of ATCI, would be agents of change in Ukraine's leasing industry, in the hope that those companies would motivate other companies to change as well. The companies that ATCI worked with specialized in financing capital equipment rather than vehicles; fostering the growth of capital equipment leasing in Ukraine was considered more important and beneficial for the country's economy and was therefore a key objective of the Leasing Component.

> ATCI assisted in drafting an investment memorandum and, in February 2008, LeaseIT–SPV undertook open public placement of UAH 15 million of secured bonds

One of the major recipients of such assistance was LeaseIT, Ukraine's first small-ticket lessor (average transaction size of $3,000), which specializes in leasing IT equipment (e.g., computers). ATCI helped LeaseIT refine key aspects of its operations and business strategy and created financial models and proposals to provide LeaseIT with access to both equity and debt financing. In June 2007, LeaseIT approached ATCI to provide assistance in the sale of a bond issue. In spite of obtaining additional sources of funding and expanding the availability of existing sources, LeaseIT was having difficulties accommodating the demand for its service. ATCI assisted in drafting an investment memorandum and, in February 2008, LeaseIT–SPV undertook open public placement of UAH 15 million of secured bonds (fixed coupon; 18%; five years). ATCI participated in meetings that LeaseIT conducted with potential investors and the LeaseIT bond issue became the first instance of leasing portfolio securitization in Ukraine.

> Over a period of two or more years, Leasing House managed to triple its leasing portfolio and increase the volume of new leases by 500%.

In 2005, ATCI started working with Lviv-based Leasing House, one of the largest and fastest growing lessors in Ukraine, whose business was predominately the financing of capital equipment. ATCI provided assistance in structuring leases, in search of alternatives for selling portfolios of existing leases and private placement of a bond issue. Over a period of two or more years, Leasing House managed to triple its leasing portfolio and increase the volume of new leases by 500%.

> Kapital Leasing and became the first true foreign venture capital–funded leasing start-up in Ukraine.

ATCI also provided advisory services to Kapital Leasing, a start-up leasing company that planned to offer traditional finance leases to mid-size enterprises. ATCI assisted in business plan preparation, investment proposals, introductions and negotiations with potential venture capital sources. As a result, Kapital Leasing secured funding from Foyil Securities, a US-owned boutique investment firm operating in Ukraine, and became the first true foreign venture capital–funded leasing start-up in Ukraine.

Finally, ATCI assisted in new market entry of foreign lessors, such as SG Equipment Finance (Societe Générale), Bank Austria Creditanstaldt (Unicredit), Raiffeisen Leasing Aval and Element Leasing (Russia). ATCI helped those companies in their due diligence process by providing market data, legal and tax analyses, and introducing them to potential partners.

CREDIT BUREAU AND CREDIT RATING AGENCY

Objective. Worldwide, credit bureaus and credit history reports serve as a key tools to increase consumer access to financing, improve bank portfolio management, and promote asset diversification and new banking products. ATCI was tasked with assessing the status of credit bureaus in Ukraine and supporting the creation and comprehensive development of credit bureaus.

Indicators.

Results. As shown in Table 3, five credit bureaus were established during the life of the project.

Table 3. Summary of Project Results for Establishment of Credit Bureau

Overall Goal						
Result Statement *Credit Information Company (CIC) established*	**Narrative Analysis:** A credit bureau cannot be successful without the use of an international operator and no international operator will operate in a new market without a thorough understanding of market conditions. To procure a successful outcome, ATCI prepared a business plan and tender documents that resulted in selection by the First National Bureau of Credit Histories of an internationally recognized operator.					
Performance Measurement: ***Operational Credit Bureau***						
Indicator	**Baseline / 2004**	**2006**	**2007**	**Sept. 2008**	**Sept. 2009**	**End-of-project target 2009**
1. Credit Bureau is registered	None	4	4	5	5	N/A
2. Business plan is completed	None	Completed	N/A	N/A	N/A	N/A
3. International operator is selected	None	2 bureaus	2 bureaus	2 bureaus	2 bureaus	N/A

Impacts. Due in no small part to the efforts of ATCI, Ukraine now has five operational credit bureaus. These companies have helped reduce bank losses, insurance and credit card fraud, and collection costs, and have thus helped bolster confidence in the banking system and the overall economy. Although the use of credit has diminished in the current economic and financial crisis, the operations of credit bureaus and use of credit history reports should assist Ukraine in its recovery.

Ukraine now has five operational credit bureaus. These companies have helped reduce bank losses, insurance and credit card fraud, and collection costs, and have thus helped bolster confidence in the banking system and the overall economy.

Activies. A law enacted before ATCI began operations required credit rating for all non-government fixed income issuance. Therefore, ATCI highlighted activities related to credit ratings within the Mortgage Lending, Fixed Income and Municipal Bond Components of the Project. ATCI aimed at promoting the development of competitive, fair and effective markets and a transparent credit rating industry.

PROMOTING CREDIT BUREAU DEVELOPMENT

In markets around the world, credit bureaus serve as the primary tool to expand the use of credit for home ownership, SME development and job creation. Prior to ATCI, no credit bureau operated in Ukraine; however, by early 2005, with the Ukrainian economy booming, income levels rising, and the banking sector becoming more advanced, more and more Ukrainians began to take out bank loans for businesses and houses and the time was ripe for the establishment of a credit bureau industry.

Legal and regulatory groundwork and follow up. During the first year of the ATCI project (2005), advisors assisted in the creation of a key piece of the financial infrastructure—the development of a crucial law that laid the groundwork for the establishment of credit bureaus in Ukraine. This law, "On Establishment and Circulation of Credit Histories," was signed by the President in July 2005; the Cabinet of Ministers authorized the Ministry of Justice to be the regulatory body for credit bureaus. The new law paved the way for the establishment of a credit bureau.

As of May 2009, regulatory authority over credit bureaus was transferred from the Ministry of Justice to the FSR. Of its own accord, ATCI contacted the FSR to present international best practices related to regulating the activities of credit bureaus. Afterward, the Chairman of the FSR voiced his gratitude to ATCI.

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In 2009, ATCI was invited by the Ministry of Justice to participate in a working group to comment on and draft amendments to the 2005 law. ATCI conducted meetings with the five licensed credit bureaus (see below) and solicited comments on amendments to the legislation. The bureaus wanted to establish mandatory requirements for creditors to supply negative information about consumers. A controversial point that was discussed is the right of the credit bureaus to inquire about consumer information from the State Tax Administration. As of the date of this report; the Committee on Finance and Banking has approved the draft law.

Creation of credit bureaus. During early 2005, ATCI assessed the credit bureau status in Ukraine and confirmed the increasing demand for credit and the fact that banks and other financial institutions needed to expand their capacity to extend low-risk loans and credit based on good information. To do this, lenders needed access to the applicant's credit history (i.e., the size, pattern, and timeliness of existing or previous monthly payments). ATCI signed a Protocol with the Association of Ukrainian Banks (AUB) in January 2005. Under the Protocol and in cooperation with other interested parties, ATCI coordinated disparate groups, consolidated interests, and assisted in the development of a credit bureau business plan (see *Attachment 13: Credit Bureau Business Plan Presentation, 28.09.2005*).

Although the expectation was to have a single credit bureau operate in Ukraine, PrivatBank and other banks refused to participate in the AUB credit bureau that was being developed. Consequently, the business plan that ATCI developed was eventually distributed to the AUB and to all other interested parties (e.g., all institutions interested in developing a credit bureau). ATCI helped establish both the First National Bureau of Credit Histories (FNBCH) and the International Bureau of Credit Histories (IBCH). In particular, ATCI fine-tuned the (generic) credit bureau business plan for and provided technical assistance to the FNBCH; it also guided the IBCH through the legal and regulatory environment and daily contact on credit bureau operations.

In 2005, a group of banks led by PrivatBank engaged a major private credit bureau operator, Experian (UK), to establish a database that included other non-bank financial sector companies with proprietary information; this database was to be used by PrivatBank's Ukrainian Bureau of the Credit Histories (UBCH). Experian was not interested in buying shares in authorized capital of UBCH, but agreed to provide software to UBCH for accumulation, organization, and distribution of credit information.

Throughout 2005 and into 2006, ATCI continued to broker, as an impartial intermediary, relations between all parties, promoting a market-based approach for structuring, establishing, and operating multiple credit bureaus in the economy. At the international level, ATCI developed and established linkages with primary international credit bureau operators interested in working in Ukraine. Domestically, ATCI drafted regulations for operators of credit bureaus and for licensing. Yet, although the numbers of borrowers and lenders continued to grow at a rapid pace in 2006, a functioning credit bureau industry was still not in place.

Fortunately, about this time the Ministry of Justice requested ATCI to carry out a series of workshops and training for its regulatory employees. The workshops presented issues related to both the practical aspects of credit bureau operations and to international experience with effective credit bureau regulation. Separately, at the request of the Ministry of Justice, ATCI prepared materials and drafted and provided technical assistance on two specific sets of regulations regarding (1) the governing of the unified registry, and (2) the inspection of credit bureaus (in the spring of 2008, the Ministry initiated inspections of credit bureaus for their compliance with laws and regulations).

Establishment of legitimate credit bureau industry. In the summer of 2006 after months of negotiations and continued assistance from ATCI (e.g., drafting an RFP for international operators), FNBCH announced that the CreditInfo Group (Iceland) had won a tender to become its international operator. The decision to select an international operator was a breakthrough in assuring the success of credit bureaus. CreditInfo, a shareholder of the International Bureau of Credit Histories (IBCH), also participated as an FNBCH shareholder and a vendor of credit bureau systems and related services, thus transferring its know-how and experience in assisting and cooperating with similar credit bureaus such as those in Sweden, Belgium, Netherlands, Austria, Italy, and Switzerland.

The decision to select an international operator was a breakthrough in assuring the success of credit bureaus.

In January 2007, the three established Ukrainian credit bureaus that follow international standards of practice—FNBCH, IBCH, and PrivatBank's UBCH—received licenses. These credit bureaus have begun gathering data that will result in the commercial sale of credit reports. In 2008, no credit reports were sold to individuals, but an estimated 64,000 credit reports were sold to credit bureau partners on a contract basis. During the first three quarters of 2009, however, only an estimated 15,000 credit reports were sold to partners. The drop in the sales of credit reports is attributed to the financial and economic crises.

Customer protection efforts. Starting in 2008, ATCI focused on the continued development, promotion, and usage of the credit bureau system through ongoing efforts to ensure that the nascent credit reporting industry was in compliance with international standards of best practice. Additional objectives included the education of customers in about credit bureau operations and benefits and the need to maintain good credit histories.

Since the Fall of 2008, ATCI has monitored the problems of credit bureaus as they operate under the current "economic crisis" conditions. In this respect, ATCI has advised the regulator about the need to prevent credit bureaus from selling credit histories to collection agencies as a source of income. Such actions would not only represent bad judgment on the part of credit bureaus, but are immoral and possibly illegal. As of the date of this report, no Ukrainian credit bureaus are known to have sold credit history reports to collection agencies. Because of ATCI concerns and efforts in this area, the Ministry of Justice has drafted a collection agency law (with ATCI assistance).

In 2009, ATCI drafted, published, and distributed 10,000 copies of a FAQ (frequently asked questions) brochure about credit bureaus' activities related to current legislation as well as current Ukrainian and international best practices. The brochure is intended to educate consumers and make them more aware of the benefits of having credit histories, including the possibility of receiving faster and lower cost credit through better credit histories and higher credit scores. See *Attachment 14: Brochure FAQs for the Consumers with Regard to CB, 06.2009*.

One more noteworthy activity of ATCI in the realm of customer protection: ATCI actively promoted the need to have customer consent clauses on credit applications that allowed the credit bureau to gather credit history information about the customer.

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Credit bureau conference. USAID/ATCI co-sponsored and actively participated in the international credit bureau conference held in Kyiv at the end of September 2006. The main objectives of the conference were to discuss (1) the important role credit reporting and credit scoring play in modern risk management and (2) what constitutes an enabling regulatory environment for the efficient running of credit bureaus. The conference also aimed at establishing cross-country networks to share experiences and provide a forum to promote regional cooperation. The conference was attended by 250 participants including representatives of the credit bureau community from Ukraine, Russia, Georgia, and Kazakhstan; officials from Moldova; senior managers from Experian and CreditInfo; bankers and representatives from the Ukrainian financial and non-financial sector; and journalists and government officials. The conference participants discussed the implications of the new legislation for the operations of credit bureaus and lenders as well as the experience of successful credit bureau operations in the region.

LOBBYING FOR NON-MANDATORY CREDIT RATINGS

A series of activities within the ATCI Work Plan relates to credit ratings. In particular, credit ratings affect all fixed-income nongovernmental issuances, and therefore, ATCI highlighted credit rating activities within the Mortgage Lending, Fixed Income, and Municipal Bond Components of the Project.

ATCI aimed to promote the development of competitive, fair, and effective markets and a transparent credit rating industry in Ukraine. The focus during the last part of ATCI was to eliminate mandatory credit rating requirements through amendments to provisions of related legislative documents. A secondary goal was to draft a credit ratings law that stipulates the activities and describes the regulation of credit rating agencies. The credit rating sub-component of ATCI was successful insofar as domestic credit rating agencies were established and international credit ratings accepted, and mandatory credit ratings were eliminated for some activities. However, as described below, ATCI urged the SSMSC to authorize more domestic credit rating agencies and also lobbied to have the mandatory credit rating requirement totally eliminated in conjunction with the adoption of a new law on credit ratings.

Legal and regulatory foundation for mandatory credit rating. In April 2004, credit ratings for the domestic market were introduced in Ukraine by the law "On Approval of the Concept for Development of the Rating System for Regions, Sectors of the National Economy, and Business Entities." This law was preceded by an SSMSC regulation dated July 2003 stating that domestic issuers must submit a credit rating from an authorized domestic credit rating agency or an international rating agency such as Fitch Ratings, Moody's Investor Services, or Standard and Poor's.

Working to eliminate mandatory credit ratings. In 2004, ATCI developed a working partnership with the Ukrainian Association of Investment Businesses (UAIB), to explore and promote the elimination of mandatory credit ratings. ATCI analysis and experience indicated that mandatory credit ratings increase the fixed costs of issuance, especially for small issues, and limits competition in the Ukraine rating services market. In addition, ATCI and UAIB wished to foster greater transparency in the published rating methodologies, including the specific rating criteria, published strengths and weaknesses, and description of the factors on which the agency judgment is based. The rating must reflect the debt burden relative to resources, debt service coverage, and clearly identified sources of cash to repay the debt as well as income, asset, liability and cash flow numbers.

On 22 January 2005 the SSMSC, in an effort to regulate the bond issuing activity, held the first round of the tender for selection of authorized rating agencies. A total of seven Ukrainian credit rating agencies applied. Four of these were shortlisted after the first round: Credit Rating Ltd, IBI Ratings, Stock Market Agency Ltd, and Ukrainian Agency of Financial Development. However, market participants claimed the tender process required by existing and draft regulations was not followed and that a comprehensive evaluation of each agency was beyond the scope of the SSMSC. In the end, Credit Rating Ltd was the only agency authorized by the SSMSC; it remains the only authorized Ukrainian credit rating agency today.

Thus, in addition to having a ready market (credit ratings mandated by law), Credit Ratings Ltd has a virtual monopoly on the market (a credit rating from an international agency costs approximately four to five times that of a domestic rating). ATCI has urged the SSMSC to authorize more domestic credit ratings agencies to make the environment more competitive environment and increase its efficiency. To date, however, the SSMSC has not authorized another domestic credit ratings agency.

In 2006, as part of the ATCI program evaluation process, ATCI commissioned a white paper, *Ratings in Ukraine*. The paper, prepared by an international expert consultant and presented in November 2006, reflected a thorough review of and recommendations based on the on the international credit rating industry. The major conclusion was that mandatory credit ratings on fixed income issuances is **not** a best international practice (see *Attachment 15: White Paper "Ratings in Ukraine."*

The major conclusion was that mandatory credit ratings on fixed income issuances is **not** a best international practice

In 2007, the UAIB defined the continuing problems in the rating market as being related to limited competition, a non-transparent market, and an acute need to change the legal requirement for mandatory ratings of issuers and issues of securities. UAIB was concerned that the draft amendments to the existing law did not addess the issue effectively and that a new draft law would be required. Once again, the ATCI and UAIB partnership lobbied for the drafting of a new law.

Throughout 2007 and into 2009, ATCI took up the challenge to eliminate mandatory credit ratings requirements by preparing amendments to provisions of related legislative documents that reflected mandatory credit ratings. ATCI developed a draft law, shared with the SSMSC, which not only eliminates mandatory ratings in Ukraine through amending relevant laws, but also introduces a regulation of rating activity and supervision in accordance with best international practices and latest trends in regulating rating agencies under financial crisis conditions.

On 5 June 2009, two days after his appointment, the new SSMSC Chairman announced plans by the SSMSC to eliminate the mandatory credit ratings for issuers. ATCI met with the new Chairman and pledged to work together on eliminating mandatory credit ratings and drafting a new law on credit ratings. ATCI submitted the draft law as well as amendments to provisions in existing legislation and regulations that previously referenced the mandatory credit ratings. As the ATCI Project came to a close, ATCI and UAIB sought a Parliamentarian to sponsor these amendments and the draft law for Parliamentary approval.

As the ATCI Project came to a close, ATCI and UAIB sought a Parliamentarian to sponsor these amendments and the draft law for Parliamentary approval.

In August 2009, the Cabinet of Ministers resolved that municipalities gaining credits from financial institutions do not need to have a credit rating; however, the Cabinet did not change the requirement for municipalities issuing bonds to obtain a credit rating. Unfortunately, this requirement continues to add to the cost of borrowing through bond issuance.

CONTINUING DEVELOPMENT OF CREDIT RATING: RECOMMENDATIONS

Existing Laws and Regulations still refer to mandatory requirements for credit ratings. ATCI has identified all existing laws and regulations that have provisions relating to mandatory credit rating requirements for their elimination.

ATCI drafted a Credit Rating Law, which also regulates credit ratings agencies; this draft law was submitted to the SSMSC and to the ULIE and UAIB for ultimate submission to Parliament. The Draft Law incorporates all provisions of existing laws and regulations that have provisions relating to mandatory credit rating requirements needing elimination. It is imperative that SSMSC makes the submission to Parliament (or through the UAIB) to eliminate all provisions relating to mandatory credit ratings requirements and secondarily to adopt a Credit Ratings law.

GENDER EQUALITY

All ATCI tasks presented opportunities to identify and address gender bias and to encourage gender equality. ATCI pledged to actively promote gender equality throughout Ukraine's financial sector and, subsequently, all ATCI training and professional development activities included a gender balance objective during the invitation process as well as in delivery of content. In situations where gender underweighting occurred, post-event analysis was conducted to understand the reasons behind it.

ATCI programs related to gender have political and cultural implications; they aim to improve opportunities for increased income and empowerment for both women and men. ATCI management recognized the importance of carrying out gender sensitivity training for its own staff in order to have a solid basis for the monitoring participation of the project training programs. The Project's full-time staff was balanced between men and women, both in technical and support functions. During the last month of the Project, for example, the staff included 11 women out of a staff of 21 (52%); these women had professional and technical capabilities including finance, law, and interpretation.

In addition, ATCI worked closely with the Ukrainian National Mortgage Association, the Association of Ukrainian Cities, the USAID-funded Commercial Law Center (CLC), and other organizations that understand the importance of gender sensitivity with respect to the development of product and services. ATCI drafted material and articles for publication and public distribution that emphasized this important issue and ensured that project training and professional development activities were designed and implemented with gender balance in mind.

Over its five-year life, ATCI monitored project training programs by:

- Examining the program to ascertain whether there any provisions might discourage persons of one sex or another from participating;
- Inquiring about how program outreach is conducted to understand whether these procedures may be affecting participation by gender differently;
- Examining the actual patterns of participation by gender in selected programs, to the extent permitted by the data; and
- Attempting to understand the causes of differential participation by gender, and to make appropriate changes.

For example, two certification programs—the Certified Leasing Specialist (CLS) and Certified Mortgage Lender (CML) programs—aimed to help market participants in the leasing and mortgage lending industries attain world standards of practice. ATCI ensured that a strong demand existed for these programs through setting working groups to develop the training courses. In Ukraine, the CML program has graduated 113 participants, 54 (48%) of which are women. Likewise, the CLS program in Ukraine has graduated 104 certificate-holders, 56 (54%) of which were women.

LESSONS LEARNED

TRAINING PROGRAMS

Overall results of these CML and CLS training programs have been to develop a well-trained cadre of mortgage and leasing industry professionals who use international best practices in order to ultimately provide better service for consumers. The programs will continue on a commercial basis.

Lessons Learned: In developing economies, there is a great desire to learn best and international practices; in order to receive more developed education and skills, participants are willing to pay reasonable fees; training providers are willing to extend training on a commercially viable basis. During crisis situations, as developed in 2008-09, demand declines as business slows, and therefore puts in jeopardy the sustainability of training programs. It is important for the training providers not only to make a profit, in order to be sustainable, but also train the financial professionals before the crisis ends so that they will be able to meet increased demand for their services and for access to credit when the crisis wanes.

MORTGAGE COMPONENT

How to write covered bond law: A covered bond is bond secured by a pledge of a mortgage pool (or pool of other financial assets) that remains on the balance sheet of the issuer for the entire term of the bond. The bond is a complex amalgam of bond and mortgage mathematics, legal structures and specific auditing procedures.

Lesson Learned: The laws of most countries support covered bond issuance without a separate covered bond law. If it is decided to draft such a law, however, the drafting process should be overseen by a covered bond practitioner assisted by one or two local lawyers. Lawyers alone are unlikely to have the mortgage, bond and audit vocabulary necessary to draft a useable law.

FIXED INCOME/GOVERNMENT BOND COMPONENT

To assist effectively in building and developing a market it is essential to use a comprehensive approach which would include a whole range of tools and methodologies, such as international conferences for intensive exchange of opinions and working out of guidelines, education of governmental officials in terms of best international practices, engagement of international experts (as well as national if available) both from developed markets and from the countries that have just resolved the same problems, as well as day-to-day work with respective bodies to ensure implementation of all the recommendations made.

LEASING COMPONENT

Positive results in market development can be achieved despite a non-favorable regulatory environment by improving business standards and building the capacity of market participants through comprehensive training programs based on best international practices as well as by continuous public awareness and outreach campaigns.

CREDIT BUREAU

ATCI with USAID determined that initiating an operating Credit Bureau (CB) along international best practices is important to the development of access to credit at financial institutions. ATCI signed a protocol with the AUB to work together in establishing one (1) Credit Bureau. However, Privatbank and other banks did not want to cooperate with the AUB-planned CB. ATCI prepared a business plan in 2005 and tender documents (for an international operator) that resulted in selection by the FNBCH of an internationally recognized operator. The business plan was available and distributed to all that wanted it. Another credit bureau directly assisted by ATCI in its development, IBCH, was established and licensed, also attracting an international shareholder. In 2007, 3 CBs were licensed and today, there are 5 licensed Credit Bureaus. Since 2008, ATCI has tried to lead the way for merging the credit bureaus into 1, maybe 2. Executives of the CBs do not have the desire to merge, which could lead to their job losses and/or their company's profit decline.

Lesson Learned: (1) A job well done and (2) competition are not necessarily good. There are gaps in credit bureaus having complete credit histories. A credit report from one credit bureau may be 'good' while a credit report from another credit bureau may be 'bad' for the same individual. Credit bureaus do not share information. Perhaps what is truly the optimal situation in Ukraine at this point of development along with the size of its population is having only one (1) credit bureau with international shareholders and using international software. ATCI should have kept the business plan confidential, used by only 1 credit bureau.

MUNICIPAL COMPONENT---A MULTI-PROCESS EFFORT WITH CROSS- CUTTING EFFECTS

ATCI partnered with the Association of Ukrainian Cities to identify and assist with finding alternative sources of financing for credit seeking cities. As the legal and regulatory environment posed obstacles for municipalities to access financial markets, ATCI needed to work with the MOF and SSMSC to reform the environment through drafting and amending various laws and regulations. Furthermore, the mandatory credit rating requirements within the legal structure posed specific hurdles that made bond issuance inefficient for alternative financing. Gaining a credit rating improved financing efficiencies for larger and more fiscally sound Municipalities while smaller municipalities could not afford the cost of a credit rating related to their smaller proposed issuance. Therefore, ATCI needed to eliminate the requirements for mandatory credit ratings. The municipalities themselves needed to understand the benefits as well as certain risks associated with bond issuance, and required assistance in developing documents for the city councils, regulators, and securities exchanges. While working on the 'supply' side of the bond issuance, ATCI also worked in developing the 'demand' side by preparing materials for investors, conducing road shows showing benefits of a particular bond investment, and by suggesting market rates that would be beneficial to the issuer while at the same time attractive for investors. For investors to be able to buy and sell their municipal bond investments, ATCI assisted in gaining exchange listing.

Lesson Learned: The successful bond offerings by Municipalities takes more than just finding creditworthy cities. ATCI combined multi-faceted activities of national and international experts to positively effect or otherwise reform Ministries, Regulatory Bodies, legislation and regulations for primary issuance and secondary market trading, exchange listing, and the purchasing and selling of these municipal bond investments. A similar approach led to a successful initiation of the Domestic Government Bond Market. ATCI Fixed Income/Government Bond Component learned lessons from ATCI activities and approaches utilized in the Municipal Financing Component.

ACCESS TO CREDIT INITIATIVE
UKRAINE & MOLDOVA

FINAL REPORT - MOLDOVA

Contract Number: 121-C-00-04-00713

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LIST OF ATTACHMENTS

RELATED TO PROJECT, GENERAL

1. Work Plan
2. Staffing

RELATED TO MORTGAGE LENDING

3. Success Story of CML Program I
4. Guidance for Financial Institution Clients on Residential Mortgage Lending
5. Mortgage Market Survey 2006/2007
6. Legal structures and monitoring mechanism of mortgage bonds, proposed for Moldova
7. Guide to Preparing for Issuance of Covered Bonds in Moldova
8. Presentation "Managing Mortgage Portfolio Risk"
9. Excel Mortgage Portfolio Risk Management Template

RELATED TO FINANCIAL LEASING

10. Leasing Sector in Moldova BENCHMARKS, 2006/2007
11. Floating Charge Presentation
12. FAQ Brochure re: Floating Charge
13. Leasing Problems and Possible Solutions
14. Legal Climate for Companies Coming into Moldova

RELATED TO FIXED INCOME AND FINANCIAL CRISIS

15. FAQ Brochure on Fixed Income
16. Agenda Bond Conference
17. Letter of Appreciation to ATCI Moldova from Chairman Cibotaru re: Bond Conference
18. Work Plan for Bond Regulation Development
19. List of Statutes for Modification for Bond Regulation
20. Sub-prime Crisis PowerPoint Presentation
21. The Global Financial Crisis

CURRENCY EQUIVALENTS

End of last quarter 2006, avg. USD 1 = MDL 13.15
End of last quarter 2007, avg. USD 1 = MDL 11.34
End of last quarter 2008, avg. USD 1 = MDL 10.58

ACRONYMS AND ABBREVIATIONS

ACAP	Accounting and Auditing Professionals (CLS Training Provider)
AMP	Average Monthly Prepayment
ATCI	Access to Credit Initiative Moldova (the Project)
BAM	Banks Association of Moldova
CEO	Chief Executive Officer
CIS	Commonwealth of Independent States
CLPF	Certified Lease Professional Foundation (US)
CLS	Certified Leasing Specialist
CML	Certified Mortgage Lender
CNVM (Rom)	National Securities Commission (Eng)
COP	Chief of Party
CRA	Credit Rating Agency
CTO	Cognizant Technical Officer
DCA	Development Credit Authority
EBRD	European Bank for Reconstruction and Development
EUR	Euro
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
IUE	Institute of Urban Economics (Russia)
LOE	Level of Effort
LTV	Loan-to-Value
MAIB	Moldova Agroindbank
MDL	Moldovan Lei
NBM	National Bank of Moldova
NCFM	National Commission of Financial Markets
NSC	National Securities Commission
P&I	Property and Indemnity (insurance)
P/L	Profit and Loss
SEC	Securities and Exchange Commission (US)
SME	Small and Medium Enterprises
USD	US Dollar
VAT	Value-added Tax

EXECUTIVE SUMMARY

Access to Credit Initiative/Moldova (ATCI/Moldova), the "Project," implemented by The Pragma Corporation, USAID-contract number 121-00-04-00713, was established under the supervision of ATCI/Ukraine, with a separate Country Director in Moldova reporting to the Chief of Party in Ukraine. ATCI/Moldova was originally set up by USAID as a two-year contract, running from October 2006 through September 2008. Negotiations between USAID and The Pragma Corporation began during the summer of 2008 to extend the contract on a "no cost" basis, utilizing part of the remaining budget from the ATCI/Ukraine project. USAID approved ATCI/Moldova to be extended for 5 months, from October 2008 through February 2009.

The scope of ATCI/Moldova is similar to that of ATCI/Ukraine, yet narrower and more focused regarding the major components and tasks.

The three (3) major components of the ATCI/Moldova project are:

- Mortgage Lending,
- Financial Leasing, and
- Fixed Income.

A fourth component, "Development Credit Authority (DCA) Monitoring" was added in the project's second quarter.

The purpose of the Project was to mobilize credit in Moldova for the use of small and medium businesses, prospective homeowners, and farmers.

A summary of all components and related activities is presented in the USAID-approved Work Plan, *The Access to Credit Initiative/Moldova Work Plan* (final approved Work Plan as **Attachment 1**). This Work Plan was approved by USAID on an annual basis, and was amended as activities were added or deleted periodically throughout the life of the project. The Work Plan was approved after lengthy discussions with the USAID Cognizant Technical Officer (CTO) and Project Manager, along with the ATCI Chief of Party (COP) and ATCI Moldova's Country Director. Some originally proposed activities, particularly those under the Mortgage Lending component, were notated "as possible in Moldova" or "as appropriate in Moldova," which related to the macro environment and developments in Moldova which were beyond the scope of the ATCI/Moldova Project. Some infrastructure activities under that component were, in fact, deleted from the Work Plan. Staffing throughout the Project for long-term as well as short-term employees, can be found in **Attachment 2**.

The objective of the Mortgage Lending Component was to establish a viable, effective and efficient mortgage lending sector in Moldova. This was to be accomplished by providing technical, advisory, and training assistance to the National Bank of Moldova (NBM), and to commercial banks and other financial institutions, in developing the primary and secondary markets and related mortgage infrastructure. A Certified Mortgage Lender (CML) Training Program has been adapted for Moldova and used to build the capacity of commercial banks and other financial institutions to undertake mortgage lending using standardized, transparent procedures for both borrowers and lenders. Additionally, technical assistance has been provided to commercial banks and financial institutions to lower the risks associated with mortgage lending and improve the transparency of mortgage lending practices.

The objective of the Financial Leasing Component was to create a supportive environment for modern financial leasing. This was achieved by (1) building the capacity of leasing companies through training and advisory services; (2) provision of training for potential lessees, farmers, regulators, and other interested parties, such as vendors and banks; (3) consulting with potential foreign investors to create or invest in leasing companies and or provide assets available for leasing; and (4) conducting public awareness efforts. A Certified Leasing Specialist

(CLS) Training Program has been adapted to the Moldovan context and presented to (potential) leasing professionals, and to CLS training providers for delivery of training in Moldova.

A key goal for both Mortgage and Leasing Components was to ensure continuity of the training programs after the Project ends through "training of trainers" activities. In this regard, ATCI/Moldova has selected local training providers to carry on the training and certification programs according to international standards. The training providers for the CLS and CML programs have been selected; trainers from these providers have attended the relevant training courses.

The objective of the Fixed Income Component was to expand the availability of capital to corporate borrowers through the issuance of corporate bonds. The first "bond issue" in Moldova occurred in 2002. Since then, there have been only a few other corporate bond issues. A total of 10 companies have issued 11 bonds for a total of 36 million lei, or about USD3 million (at exchange rates as of the beginning of the Project). All but one bond issuance was initiated with convertible (to equity) features, to facilitate a takeover or merger of the company. The remaining bond issue was effectively a private placement or loan in the form of a bond issue. The Project also worked with the National Commission of Financial Market (NCFM), the newly transformed Mega Regulator, to ease the legislative and regulatory burdens on bond issuance. At the same time, the Project helped to build the capacity of and provide action plans for the National Securities Commission in its transformation to Mega Regulator for Non-Bank Financial Institutions in July 2007, after the Law on the National Commission of Financial Market was adopted. Concerns such as transparency and disclosures of issuers were the main focus for bond development, while the capacity building elements focused on legislative reform and the regulatory and enforcement activities of the Mega Regulator.

The Development Credit Authority Monitoring Component was added, at USAID's suggestion, in late February 2007, as a follow-up to a previous USAID project (BIZPRO). The DCA provides partial loan guarantees for private sector investments/loans in Moldova, through six commercial banks and the Rural Finance Corporation. The DCA-related activities of the Project were ongoing, for the most part, and included (1) monitoring of how the financial institutions are utilizing the partial guarantees; (2) monitoring of how they are submitting claims; (3) assisting the institutions in completing surveys; (4) assisting them in preparing semi-annual reports for USAID; and (5) verifying the reports of the financial institutions that are submitted through the credit monitoring system.

The Project supplemented its outreach and public education through its web site, www.atci.com.md. This site is also linked on the ATCI/Ukraine's web site, www.atci.com.ua.

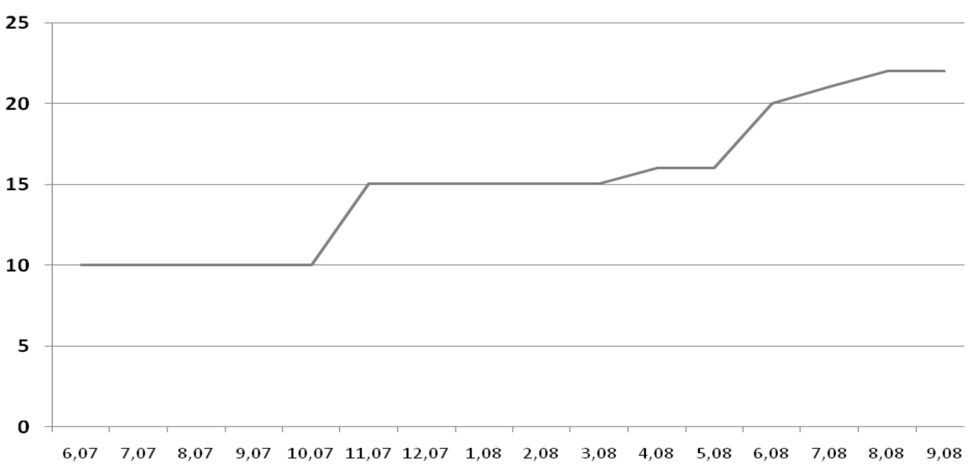
MORTGAGE LENDING

The objective of the Mortgage Lending Component was to help establish a viable mortgage lending sector in Moldova by providing technical, advisory and training assistance to the National Bank of Moldova and to mortgage lending banks and non-bank financial institutions. A Certified Mortgage Lender (CML) Training Program was adapted for Moldova and presented in order build the capacity of commercial banks and other financial institutions to undertake mortgage lending using standardized, transparent procedures. Technical assistance was provided to banks and non-bank financial institutions to help them better manage the risks associated with running a mortgage portfolio. The Project conducted semi-annual Mortgage Market Surveys to quantify the amount of mortgage lending and identify its terms. The Project also provided technical assistance to the largest mortgage lending bank in Moldova to help it structure a mortgage-covered bond; however, the global financial crisis eventually prevented actual issuance. In the end, all of these activities were either curtailed or severely impacted by turmoil in Moldovan credit markets beginning in the spring of 2008 and followed almost immediately by the paralyzing events of the global financial crisis.

In the spring and summer of 2008, the Moldovan banking sector suffered a series of seemingly unrelated shocks that sharply curtailed mortgage lending for the quarter and probably for a longer period.

First, the National Bank of Moldova tightened its stranglehold on commercial bank lending, raising required reserves from 20 percent in June to 21 percent in July and again to 22 percent in August. At the same time, NBM raised the refinance rate from 16 to 18 percent. Both measures were designed to bring inflation, which had climbed to 17.5 percent in June, under control. NBM may indeed bring the inflation rate down, but it will also take the growth rate of mortgage lending down with it. See diagram below reflecting the upward trend of the NBM reserve ratio requirements.

National Bank of Moldova: Required Reserves Ratio



Source: National Bank of Moldova, ATCI

Second, the precipitous slide in the exchange value of the **US dollar** (USD) that began in late May 2008 accelerated during the quarter, reversing only in mid-September after particularly worrisome developments in the **global financial crisis**. The plunging value of the USD against the Moldovan lei (MDL) made it almost impossible for local banks to attract USD deposits. Roughly 50 percent of Moldovan bank assets are denominated in foreign currency, of which about 80 percent is USD. The local banks, therefore, were forced to raise rates on USD deposits and to curtail USD lending in order to remain within **currency open position limits** mandated by NBM. About 25 percent of mortgage lending is typically denominated in USD and euros (EUR), and that share of total mortgage lending was adversely impacted by the shortage of USD in the summer, when most real estate transactions in Moldova concluded. See chart below reflecting the movement of the USD/MDL exchange rate.

USD/MDL Exchange Rate

Last, Parliament passed a Mortgage Law that includes two provisions banks vigorously oppose. The new Law requires that (1) that banks use independent—as opposed to in-house—property appraisers; and (2) property securing a mortgage loan be insured against loss or damage in the amount of appraised replacement value.

Banks oppose independent appraisers on the grounds that appraisers in Moldova are, in general, incompetent and untrustworthy; reports they generate are not adequate for the banks' lending needs. There is a relatively simple solution to this problem if the banks will begin cooperating with one another.

The banks' opposition to property and indemnity (P&I) insurance based on the appraised replacement value of the real estate is somewhat more complex. First, the banks are not opposed to P&I insurance per se; they are opposed to calculating P&I insurance on replacement value, which is lower than loan value, on which P&I is currently calculated. Calculating insurance on replacement value, the banks argue, increases the cost of the mortgage to the borrower and will significantly dampen demand for their mortgage products.

Cleary, anything—be it new legislation or higher required reserves—that has a negative impact on mortgage lending in Moldova also put in jeopardy certain tasks set forth in ATCI's Mortgage Component Work Plan.

Mortgage lending began in earnest only in 2007, the year in which ATCI/Moldova began conducting Certified Mortgage Lending training courses. Mortgage lending increased almost 300 percent in 2007, obviously from a very low base, and it is not unreasonable to attribute much of the increase to the banks' confidence in the underwriting standards and procedures that CML promulgated in its certified mortgage lending specialists.

PRIMARY MORTGAGE MARKET

Certified Mortgage Lender (CML) Training Program

ATCI/Moldova was very successful in the implementation of the Certified Mortgage Lender (CML) program, through its initial development, adaptation, presentation, and eventual transfer to a sustainable Training Provider. Developments in the implementation of the CML program were as follows:

1. ATCI/Moldova initiated its development of the primary mortgage market through assessments conducted by the short-term Certified Mortgage Lenders (CML) Program trainers, Alexandre Kopeikin and Natalia Rogozhina, from the Institute of Urban Economics (IUE) in Russia. They conducted meetings with the institutions and major players conducting residential mortgage activities in Moldova. These meetings took place during the first quarter of the Project's inception, the period October – December 2006. Meetings were held with nine mortgage institutions, the National Bank of Moldova, the EBRD, and the National Securities Commission. They also gathered information on the mortgage environment in Moldovan and adapted it for

the CML courses which began in the following quarter. These were the same CML trainers who developed the CML course in Russia during the 1990s, and later adapted and presented the course in Kazakhstan in the early 2000s, and in Ukraine for ATCI in the period starting in 2005-06 through 2008-09.

During the second quarter, the first and second modules of the CML Program were presented by the experts from the IUE in the Project's training center to mortgage professionals, including three (3) prospective training providers. The presentation was in the Russian language. Candidate trainees were nominated by their employers—banks and financial institutions that issue or are interested in issuing mortgages. Those selected were from the more active mortgage institutions; in a class of 20-26 trainees, including 19 mortgage professionals, 14 institutions were represented—of which 10 were mortgage lending companies or agencies. Note: There are only 16 commercial banks in Moldova, and not all of them were issuing mortgages at that time. (See relevant quarterly reports for details on the subject matter included in the training courses.)

2. The Project presented the third and final Certified Mortgage Lenders training module, and thus completed the first CML training program, in the third quarter of ATCI/Moldova. Each training module was presented over four (4) days and ended with an exam; a total of total of 25 trainees passed all three exams and received CML certificates. See **Attachment 3**, "Success Story of CML Program 1".
3. ATCI upgraded and improved the CML courses throughout the life of the Project. During this first training program as well as all subsequent CML programs, trainees completed surveys on the relevance of the course work, the quality of the training providers, and the effectiveness of the overall training courses. Both the program and the providers received very high marks (generally in the upper 85 percentile and higher) as to the relevance and quality of information presented on international best practices. (See relevant quarterly reports for details of these assessments.)
4. Due to scheduling conflicts of the IUE trainers, the next CML training program was carried out in the Project's fifth quarter (October – December 2007). Prior to the inception of this training course, the training materials were updated and revised by the IUE trainers and the Project's Mortgage Advisor to reflect changes in the Mortgage Law. It must be noted that the Mortgage Law, with provisions submitted to the EBRD (original drafters of the Law) by ATCI and subsequently added to the was not enacted until the eighth quarter of the Project (July – September 2008).

   Trainees for this second CML program were selected as they were for the first program, with the addition of other interested parties, such as staff of the National Bank of Moldova. The second Certified Mortgage Lender program had 19 graduates, with certificates awarded to trainees from six mortgage banks, one mortgage agency, three training providers, a microfinance company, and the National Bank of Moldova.

   The NBM sent staff to attend the CML course to increase its understanding of the banks' needs and processes, and to be able to better regulate the mortgage practitioners. During the course, a special two-hour meeting/discussion was held, at NBM's request, with 16 representatives of NBM and Project staff on risk management in mortgage lending. Representatives of NBM's Banking Regulation and Supervision Department and its Market Operation Department attended the meeting.
5. During the sixth quarter of the project, at the request of the US Ambassador, ATCI Moldova initiated a CML program in the Transnistria region of Moldova. The US Ambassador wanted more USAID activities to be conducted in that region, and ATCI/Moldova received approval from the Ambassador to conduct this training. During the prior quarter, key Project staff, along with a USAID executive, had visited Transnistria to determine whether the top three banks had an interest in sending staff to attend the training course. There was very favorable reaction among all these and five other banks (for a total of eight), although only two were currently issuing mortgages. In preparation for the presentation by the IUE trainers, the Legal Team of ATCI/Moldova reviewed the Transnistria Law on Mortgage, for deficiencies as well as overall

content. This assessment was sent to the trainers to be presented during the anticipated CML training in Tiraspol, the regional capitol.

In this training program, in Tiraspol, six of the eight banks were represented, with a total of 24 trainees. The selection process was similar to that for the Chisinau trainings; the banks nominated personnel to attend, and the Project's Mortgage Advisor selected trainees based on size and mortgage activity of the banks. This training was completed early in the seventh quarter, with 21 trainees passing all the exams and receiving their CML certificates.

6. ATCI also began the third CML course in Chisinau during the sixth quarter. This training was presented by Banks Association of Moldova (BAM) Consulting, selected by ATCI via a tender for CML training providers that would be able to sustain the training after the end of the Project. BAM Consulting is the training arm of the Banks Association, which is the major advocate for banks in Moldova as well as the main institution providing training and seminars for banks and other financial institutions. BAM Consulting will continue CML training in Moldova on a commercial basis after the Project ends. The BAM trainers were coached and monitored by trainers from the Institute of Urban Economics.

   This Chisinau training included 21 participants representing ten banks, two mortgage companies, of which 20 passed the examinations and received CML certificates. This brought the total number trained by the Project to more than ninety mortgage professionals, of which eighty-five (85) have received CML certification.

   As the world became mired in the financial crisis, the Country Director made a separate presentation on the **sub-prime crisis** to the CML program attendees as part of training program.

7. The first commercially presented CML course by the BAM Consulting was initiated in the ninth quarter of ATCI/Moldova, the October – December 2008 period, and was completed in the final quarter in February 2009. The number of trainees was down from an average of 20 per program, due to the slowdown in mortgage activity. In all, 13 trainees participated in Module 1, representing 5 commercial banks, 1 audit company, and 1 government body; 10 participated in Module 2, representing 5 institutions; and 19 participated in Module 3, representing 6 banks (12 from 1 bank, who did not participate in Modules 1 and 2). Seven received certificates, bringing the total of CML certificate holders in Moldova from the inception of the ATCI project in October 2006 through February 2009 to 92 BAM Consulting will translate the training program from Russian into Moldovan (Romanian) for future presentations in the Moldovan language.

LEGAL FRAMEWORK REVIEW

At the time of ATCI/Moldova's inception in October 2006, the EBRD had already drafted a Mortgage Law and submitted it to the Minister of Economy and Trade, for his review and subsequent presentation to the Parliament. This was the 4th draft developed by the EBRD, and it focused on the development of the primary mortgage market, with no provisions for the secondary market, which would have included mortgage-covered securities. These provisions would have included securing the rights of bond holders, along with the assurance of the transferability of bonds and underlying assets for the issuance of mortgage- covered bonds. The Project decided not to propose provisions relating to the secondary mortgage market, as this would have further delayed the Law's adoption.

During the second quarter, the Project assessed the draft Mortgage Law by establishing a "Virtual Legal Working Group," which exchanged ideas and opinions via email. The group included participants from mortgage banks, leasing companies, financial institutions, insurance companies, National Bank of Moldova, and the National Securities Commission (NSC). The participants included their comments on the Draft Mortgage Law, and responses were vetted by the Project's professional staff, which drafted provisions that were recommended for inclusion in the Draft Mortgage Law.

The Project also distributed a FAQ-type brochure for use by mortgage-lending institutions, providing answers to generic questions that borrowers may have, assisting these borrowers in the mortgage process. See **Attachment 4**, "Guidance for Financial Institution clients on Residential Mortgage Lending".

The Project's Legal Team also reviewed the Civil Code, Enforcement Code, Pledge Law, Credit Bureau (draft) Law, Law on Real Estate Cadastre, and Law on Insurance. The results of the Working Group in conjunction with the Project's efforts included:

- Drafting recommendations, including 2 provisions that were included in the Draft Mortgage Law, relating to regulation of pledge in the Civil Code and consequences of reparations to property;
- Conducting 4 meetings with the National Bank of Moldova, EBRD, and 2 commercial mortgage lending banks to discuss the draft Mortgage Law and current problems related to mortgage lending;
- Reviewing and analyzing 13 legal acts and drafts; and
- Commenting on 4 legal acts and drafts.

Additional work concluded by the Project's Legal Team included assistance to the IUE experts in adapting the CML training course to Moldovan legislation.

The Mortgage Law was adopted by Parliament during the Project's 8th quarter (July-September 2008). To help the mortgage professionals and the public understand the significance of this Mortgage Law, ATCI participated, along with the EBRD, in a roundtable discussion of the salient issues. Two of these issues were perceived by the market as forcing withdrawal from mortgage activities:

- The Law requires the use of real estate appraisers independent of the lender to establish both the market value and the replacement value of the property. Banks, which have long used in-house appraisers, questioned the competence and integrity of third-party appraisers. ATCI adopted the position that market pressures will quickly remedy the problems of incompetent and untrustworthy appraisers. Additional training to upgrade the skills and methodologies of appraisers can be provided by BAM Consulting, with donor assistance if necessary. ATCI also generated plans to bring in an international appraisal expert to assess the situation in Moldova.
- The Law makes property insurance in the amount of appraised replacement value mandatory. Most banks have long required insurance on mortgaged property, but only in the amount of the mortgage itself. At the end of 2007, average LTV (loan-to-value) in Moldova was 57 percent, but LTV is usually calculated against market value. The banks argued that making replacement value insurance mandatory increases the cost of the mortgage, therefore reducing the pool of potential borrowers. Furthermore, the Law is not clear on the meaning of 'replacement value,' which can be interpreted as meaning replacement value at any time in the future. ATCI nevertheless favors insurance on appraised replacement value, since this is international practice, and lenders and insurers should be able to agree on the operative meaning of "replacement value."

MORTGAGE MARKET SURVEYS

The Project conducted semi-annual surveys of the mortgage market, asking the mortgage companies to complete questionnaires, and then publishing the results of the surveys. ATCI/Moldova conducted and published the results of the first annual survey of Moldova's mortgage market, effectively establishing a benchmark for the local mortgage lending industry.

However, various events, adopted legislation, and added requirements for banks had a negative impact on the mortgage-related activities within ATCI/Moldova's Work Plan. ATCI's *Mortgage Market Survey* (see **Attachment 5**) is a case in point. The second quarter 2008 survey was sent to the nine participating banks in July but failed to get even one response. July and August are the high season for prolonged vacations, but ATCI suspected there might be other reasons for the lack of response. The survey was sent a second time to the same nine banks, and ATCI received four responses from lenders representing about 90 percent of Moldova's mortgage market. Their responses showed that mortgage lending was slowing down sharply from 2007: outstanding mortgages on 30 June 2008 stood at MDL 1.627 billion, only an 8.75 percent increase over outstanding mortgages at the end of 2007.

The survey of the second half of 2008, sent out in January 2009, received no responses whatsoever. Anecdotally, ATCI determined that only one of the former nine mortgage lenders was actively writing mortgages during the second half of 2008.

Below is the summary of ATCI/Moldova's surveys:

	Performance Indicators	Unit	***31.03.07***	***30.06.07***	***30.09.07***	***31.12.07***	***30.06.08***
1	Outstanding Balance	th MDL	*801,458*	*1,036,976*	*1,251,993*	*1,496,090*	*1,609,525*
2	Mortgages year to date	th MDL	*246,032*	*530,002*	*808,765*	*1,130,472*	*306,485*
3	Number of mortgages		*4,168*	*5,157*	*6,116*	*7,090*	*7,532*
4	Number of mortgages year to date		*1,060*	*2,204*	*3,363*	*4,588*	*1,023*
5	<u>Average</u> maturity	years	*Weighted average 9.1 Interval 6.3-14*	*Weighted average 10.4 Interval 6-15*	*Weighted average 10.3 Interval 6-12*	*Weighted average 10.1 Interval 6-11.7*	*Weighted average 10.5 Interval 6-12*
6	Average outstanding balance	th MDL	*192*	*201*	*205*	*211*	*214*
7	Average outstanding balance year to date	th MDL	*232*	*240*	*240*	*246*	*300*
8	<u>Average</u> LTV	%	*Weighted average 50% Interval 46-60%*	*Weighted average 53% Interval 47-70%*	*Weighted average 55% Interval 47-91%*	*Weighted average 55% Interval45-91%*	*Weighted average 42% Interval45-70%*
9	Delinquency rate (>30 days)	%	*0-2.22%*	*0-0.57%*	*0 - 1.1%*	*0-1.0%*	*0-3.26%*
10	Number of mortgage products		*1-6 Total 18*	*1-6 Total 20*	*1-6 Total 24*	*1-7 Total 23*	*1-8 Total 17*
11	New mortgage products year to date		*0-1 Total 3*	*0-2 Total 6*	*0-2 Total 12*	*0-2 Total 14*	*0-1 Total 2*
12	Mortgages as % loan portfolio	%	*Average banks 8%*	*Average banks 8%*	*Average banks 8%*	*Average banks 9%*	*Average banks 9%*

MORTGAGE MARKET INFRASTRUCTURE DEVELOPMENT

Mortgage market infrastructure includes appraisers, mortgage-related life insurance, credit bureaus, registration centers, real estate sales practitioners, and appropriate legislation and regulation. Based on the lack of financial development in Moldova as a whole, and as indicated in the ATCI/Moldova Work Plan, activities in these areas were marked "as appropriate" or "as possible," as both ATCI and USAID recognized that the completion of necessary activities might not be possible within the relatively short period of the Project. Nevertheless, ATCI conducted assessments of the (1) mortgage-related life insurance products and needs; (2) appraisal organizations and needs; and (3) credit bureau status, and feasibility of establishing a credit bureau system in Moldova. The conclusions made by the assessments should be considered, where practical, as possible activities to be developed within the industry and possibly with donor support.

MORTGAGE-RELATED LIFE INSURANCE

Early in the life of the Project, the Mortgage Advisor, along with the Country Director, met with four insurance companies to discuss mortgage-related insurance products with two other insurance companies discussing insurance products in Moldova during the Project's 2nd quarter (January-March 2007). In addition, the Legal Team reviewed the new Insurance Law and its possible impact on mortgages. Related to the assessment of insurance practices, the Project met with the major insurance company in Moldova, and with the National Bureau of Statistics to discuss and gather actuarial data and information. These discussions and assessments revealed that:

- The new Law on Insurance was passed in late 2006, but was not published in the Official Monitor until April 2007. As of the end of 2006, there were 33 insurance companies with total assets estimated at USD 57 million. According to data gathered in the last quarter 2006, the 2 biggest insurers in Moldova are QBE-Asito (46.51 million lei or a little less than USD4.0 million) and Moldasig (state-owned, about USD1.0 million). The other 31 insurance companies have assets of less than USD 1 million.
- The new Law also differentiated between life and non-life insurance companies, and requires an increased share capital level of MDL 22.5 million (approximately USD1.8 million) for life insurance companies and MDL 15 million (approximately USD1.2 million) for non-life insurance companies.
- The insurance industry is generally underdeveloped and there is low penetration of mortgage-related insurance. Most mortgage lenders in Moldova require at least property loss insurance, but some lenders do not require the borrower to obtain any form of insurance because they believe it is too expensive and will discourage portfolio growth. However, the new Law requires borrowers to acquire property insurance in order to obtain and carry a mortgage.
- As in other CIS countries, non-life insurance is more developed than life insurance, which represented only 12 percent of total collected insurance premiums for the 9 months of 2006. Motor insurance is the major type of insurance sold, representing 27 percent of total premium income in first three quarters of 2006. The new Law does not require mortgage-related life insurance.

The Project proposed to look into the feasibility of developing other mortgage insurance products in addition to mortgage life insurance. Mortgage insurance can help specific types of borrowers—young professionals, first-time homebuyers, households with modest or variable or "unofficial" income, and those with non-standard profiles—to obtain mortgages with lower down payments (higher LTV). Benefits to banks or other mortgage issuers would include (1) increased size of loan portfolio/market share from the addition of new types of borrowers; (2) increased loan portfolio suitable for mortgage-backed debt by making available greater-sized loans; (3) ability of banks to provide possible capital relief on higher-LTV loans that carry mortgage insurance; and (4) lowering the credit risk of borrowers.

Later in the Project's life, at the time shortly after the adoption of the Mortgage Law, another assessment was made of mortgage-related life insurance products. Findings and conclusions drawn from this assessment include:

- Parliament struck a provision of the draft Law that would have made borrower life insurance mandatory. This was a compromise forced on Parliament by the banking lobby, which again argued that mandatory borrower life insurance added to the cost of mortgage, reducing the pool of potential borrowers. That is no doubt true, but there are better arguments. First, it is not evident that, at this stage in the development of the Moldovan mortgage market, it is actuarially worth the additional cost of insuring against death of the borrower. Second, it is likewise not evident that Moldovan insurance companies can actually reinsure a mortgage life insurance product that covers death by any cause; currently, companies offer only an accidental death product.
- The first argument is actuarial. At the end of 2007, there were some 19,000 mortgages outstanding in Moldova. Seven thousand households with mortgages is probably too small a sample of the total population to be actuarially valid for mortality. (Estimated 2008 total

population is 4.128 million.) Further, the sample suffers from a selection bias: namely, individuals in households with mortgages are probably better educated, healthier and wealthier than individuals in the population at large.

- If this is true, then there are two implications for mortgage lenders. First, the incidence of death from any cause in the mortgage household population will be less, and perhaps significantly less, than that in the population at large. Second, since the stock of outstanding mortgages is relatively small, insurers (and reinsurers) will have to charge a relatively high price for mortality products in order to cover their selling and administrative expenses, regardless of the actual risks of mortality incidence in the insured population. If that is the case, it is probably best, in the short term, for mortgage lenders to self-insure against mortality risk (even without reserves) than to insure the risk with local insurers.

The Country Director met with representatives of local insurance companies offering mortgage life insurance products. Typically, the products insure the outstanding balance of the mortgage against accidental death of the borrower (head of household) for the term of the mortgage on a one-year renewable basis. The insurers writing these policies classify them as "general risk insurance"; that is, the companies are not carrying the policies as life insurance, and the reserves established against them are not calculated by actuaries.

Toward the end of the Project's second year (September 2008), the Mortgage Law was passed. It made real property insurance mandatory for mortgage borrowers but left life insurance for borrowers optional. Most Moldovan banks do not require life insurance for borrowers but some do, depending on the perceived life risk of the borrower, and one lender requires life insurance for all mortgages. However, the life insurance that banks are able to secure for their borrowers covers only accidental death, not death from all causes. Accident death is a general insurance product and can be written by a general insurance company, whose reserves are not calculated by an actuary, as are reserves of a life insurance company. At the time, there was only one life insurance company in Moldova, and that company did not write a mortgage life product.

In an effort to further improve the mortgage lending infrastructure, during January 2009, ATCI recruited a short-term insurance expert to investigate the current state of mortgage life insurance in Moldova, and suggest alternative products that local companies might be able to write and reinsure with European insurers. His findings are indicative of problems Moldova faces as a result of its small population and its hopes of one day joining the European Union:

- As stated above, there is only one life insurance company operating in Moldova, and that company does not offer a mortgage life product. The reason is that the mortgage market is too small, and sales of the product would not cover its administrative costs. As of June 30, 2008, there were only 7,532 mortgages outstanding in Moldova, and the same number of primary mortgage borrowers.
- From the actuarial point of view, the mortality of Moldovan mortgage borrowers will be much lower percentage than that of the population at large because of certain selection criteria: education, well-being, level of income, etc. In fact, because the average mortgage borrower is probably not in a line of work with a high incidence of fatal accidents, the mortality of Moldovan mortgage borrowers is "in the flat" of the standard deviation curve: that is, death by anything but accident of a Moldovan mortgage borrower is a rare event—a Black Swan, as they are called in Value at Risk terminology. The risk of death by anything but accident will gradually increase as the age of borrower population increases, but for the present it is extremely low. So even if the market is limited, a life company should be willing to write such a product, and probably would do so except that life insurance companies cannot insure accidental death, which is a general insurance product.
- Current law does not allow for the creation of combined life-nonlife companies in order to comply with the EU directive. However, the EU directive in question was formulated to prevent creation of more combined companies; it did not outlaw existing combined companies. Thus, mortgage lenders cannot get the kind of mortgage-related life product they need because (1) the

law prevents creation of the type of insurance company need to write the product; and (2) the mortgage market is too small to attract the interest of existing European combined companies.

The insurance consultant suggested two ways of addressing these problems. First, since death by anything but accident will be a rare occurrence for some time to come, interested mortgage lenders can insure their mortgage portfolios against pecuniary loss in some fixed amount representing one or two such occurrences. Second, they can self-insure against the same occurrence by adding one or two basis points to their mortgage lending rate and actually reserving against the Black Swan event.

(Note: For further and more detailed information in this area, the attached insurance assessment report to the Project's 10th Quarterly Report should be reviewed.)

APPRAISAL ACTIVITY

Another activity in the Work Plan marked "as possible" was to build the capacity of the real estate appraisal associations. The objective was to enable the appraisers to develop into organized, ethical, and skilled professionals.

The Project's Mortgage Advisor met with the National Real Estate Chamber in the latter part of Project's 2nd quarter. Findings of initial assessments and other relevant details are as follows:

- In August 2002 the Law on Appraisal Activity, drafted by the specialists in the Cadastre Agency and the Real Estate National Chamber, entered into force. The main effect of the Law was to declare appraisal an independent activity, with certain rules and requirements. The Law contributed to the recognition of market appraisal methods in determining the market value of real property.
- The Law introduced a system of state attestation of appraisers to ensure high-quality appraisal services. Implementing regulations led to the establishment of an Attestation Commission. Since the adoption of the Law and formation of the commission, more than 110 appraisers have been attested and awarded qualification certificates.

Regardless of these developments, however, there still appears to be a major problem relating to the various organizations and authorities creating different standards of appraisals. There needs to be an agreement on standards between appraiser practitioners and the Ministry for Land Relations.

In the Project's 9th quarter (October-December 2008), ATCI/Moldova contracted with Norman Flynn, President of the Real Property Foundation (USA), to perform a thorough assessment of the appraisal industry in Moldova. He found that the appraisal industry is in fact weak, and that one cause of the weakness is that the state-owned tax appraisal company uses its natural monopoly position to compete with private appraisal companies. Another cause was the lack of active development of the professional appraisal association. On the positive side, Norm found that:

- Universities that follow the European model would more than likely develop 4-5 years of basic education in appraisal;
- The Moldovan government understands the need to pass appraisal legislation and regulation to ensure that appraisal is stronger; and
- The Cadastre System is a good development in that it has been given responsibility to continue developing the appraisal industry.

The difficulty is that the National Chamber of Appraisals, which is a voluntary board, is in-bred and parochial in its thinking. All three of the officers have been there for a long time and believe that there is already "too much competition," and they are not eager to add other quality appraisers or appraisal education. The opportunity that the new Law gives this industry to develop an independent appraisal industry should increase the number of appraisals made available in the marketplace as the financial crisis lessens and there are more mortgages made in Moldova. (NOTE: Norm Flynn's detailed report is contained in the Project's 9th Quarterly Report.)

CREDIT INFORMATION COMPANY (CREDIT BUREAU)

Another Project activity was to "Facilitate Establishment of a Commercial Credit Information Company *as appropriate in Moldova.*" This caveat was based on the premise that while there is the need for a Credit Bureau to aid in the decision-making process for credit companies and lending institutions, the self-interests of the major lending institutions may preclude the establishment of such a Bureau. Given the size of the country, only one Credit Bureau is needed.

The Project performed an initial informal analysis in the 2nd quarter (January-March 2007) to determine the technical and financial feasibility of establishing a commercial credit information company in Moldova. A Credit Bureau serves as a financial intermediary between the lender and the borrower in order to stimulate, in the first instance, the SME and retail markets within a free market competitive economic system. However, any developmental work performed by the Project should be performed only after a Credit Information Company Law acceptable to USAID is passed and signed into law. At the time the analysis was carried out, the draft Law was stalled while the government awaited the adoption of the Mega Regulator Law, which was in Parliament and eventually signed and adopted in mid-2007. The new Mega Regulator (the transformation of the National Securities Commission into the National Commission on Financial Markets) was to become the regulatory body responsible for the Credit Bureau.

During the Project's 4th quarter (July-September 2007), the draft Credit Information Company Law passed from the Government to Parliament. ATCI/Moldova held meetings with the World Bank, which was also planning to invigorate the establishment of the Credit Bureau, to coordinate future activities.

Finally, during the Project's 8th quarter (July-September 2008), the Law was signed and adopted. It will enter into force on March 1, 2009. The Project conducted no further activities in this area.

SECONDARY MORTGAGE MARKET

Structuring Covered Bonds for Moldova

Beginning in February 2007, ATCI worked periodically with Moldova Agroindbank (MAIB) to structure and issue Moldova's first mortgage covered bond. See Attachment 6, "Legal Structure and Monitoring Mechanism of Mortgage Bonds". Covered bonds are bonds secured by a pledge of claims on the future cash flows from a bank's mortgages. The German Pfandbriefe, the largest class of covered bonds in Europe, can be traced back to mortgage bonds issued in Prussia as early as 1769. Currently, the value of covered bonds in circulation in Europe exceeds €1.9 trillion.

COVERED BONDS OUTSTANDING 2006 in EUR Mn					
	Mortgage	Public sector	Mixed Assets	Ships	TOTAL
Germany	223.306	720 835	0	4.669	**948.81**
Denmark	300.367	0	0	6.672	**307.039**
Spain	214.768	11 59	0	0	**226.358**
France	43.012	49 66	61.93	0	**154.602**
Ireland	11.9	49.914	0	0	**61.814**
Sweden	55.208	0	0	0	**55.208**
UK	50.594	0	0	0	**50.594**
Luxembourg	150	28 36	0	0	**28.51**
Switzerland	23.096	0	0	0	**23.096**
Austria	3.42	13 68	0	0	**17.1**
Italy (CDP)	0	10	0	0	**10**
Netherlands	7.5	0	0	0	**7.5**
Hungary	5.924	0	0	0	**5.924**
Czech Republic	5.543	0	0	0	**5.543**
USA WaMu	4	0	0	0	**4**
Finland	3	0	0	0	**3**
Portugal	2	0	0	0	**2**
Slovakia	1.861	0	0	0	**1.861**
Poland	453	0	0	0	**453**
Latvia	63	0	0	0	**63**
Lithuania	14	0	0	0	**14**
Total	956.18	884 039	61.93	11.341	**1,913,490**

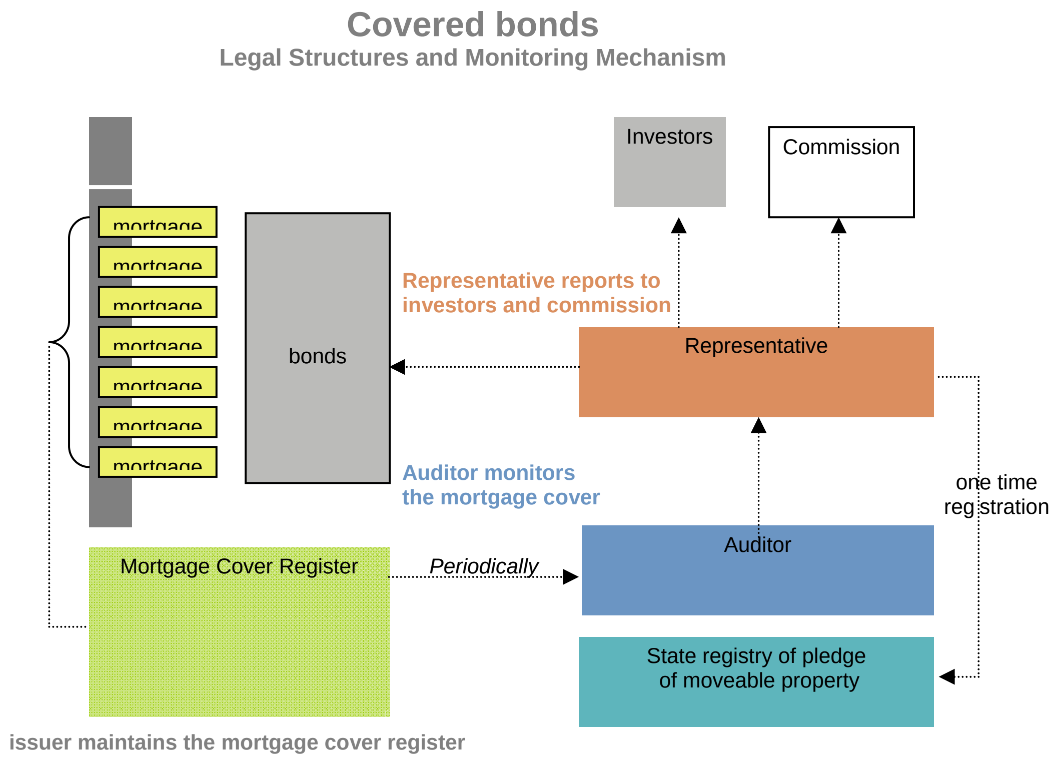
6

Source: European Covered Bond Council.

The first step in preparation for issuance of a covered bond is technical: the bank's IT specialists must adapt their software to capture certain fields of data on mortgage loans and segregate the data to constitute what is called the **mortgage pool** or, more officially, the "Register of Mortgage Cover." Once the data has been identified and segregated, the IT specialists export it to an **Excel-based template** developed by ATCI for periodic analysis of the mortgage pool. A key feature of the analysis is the **Average Monthly Prepayment** (AMP) Rate; i.e., the rate at which borrowers prepay all or a portion of outstanding loans expressed as a percentage of the total outstanding mortgage portfolio. AMP is then used to calculate the true **duration** (financial term) of the portfolio, which is in turn used to determine the **term of the bond** issue and—if there is a national yield curve—the **coupon interest rate** of the bond.

The second step in preparing for issuance is legal: the bond must be structured in compliance with local legislation; in addition to Moldova's Civil Code, there are several laws which govern various aspects of bond issuance, pledge and pledge registration, and representation (trustee). In this regard, ATCI met with **MAIB's Chief Counsel, Kiril Pulberi,** to review the primary legal constructs of the proposed bond and seek his advice on how best to proceed with registration of pledge of moveable property. The **Ministry of Justice** maintains the registry of pledge of moveable property; notaries perform the registration. Mr. Pulberi recommended that ATCI organize a meeting with **Ms. Yelena Mokan**, Deputy Minister of Justice in charge of Moldova's corps of notaries, to discuss the legal structure of the bond.

The first construct is that of a trustee, or bondholder representative, who carries out certain functions on behalf of the bondholders on the basis of Civil Code Statutes 242-258, governing personal representation (power of attorney). Under ordinary circumstances, the law requires that (1) the functions to be carried out by the representative be set forth in writing; and (2) the document defining the functions of the representative be signed by the individual delegating the authority. In the bond, the functions of the bondholder representative will be defined in the Investment Memorandum that the issuer circulates among prospective buyers; in that regard, the construct comports with the letter and the spirit of the law. However, inasmuch as physical signature of the power of attorney by every future bondholder would, in practice, seriously impede the free transfer (trade) of the bond, ATCI has proposed that the actual purchase of the bond by bondholders shall constitute signature of the power of attorney contained in the prospectus. Though the proposed construct is not specifically mentioned in the Civil Code, it comports with the spirit of statutes which extend the right of personal representation to individuals (prisoners, invalids, et al.) under some form of physical or other constraint, which prevents them from conforming with some aspect of the Law. See chart below, Covered Bonds: Legal Structure and Monitoring Mechanisms



The second construct is that of master, or aggregate, pledge. There are two issues here. The first is that the pledge agreement between the issuer and all bondholders will be signed not by the bondholders but by the bondholders' representative. Again, requiring each bondholder to sign the pledge agreement would seriously impede free trade of the bond in the secondary market. The second issue is that the pledge agreement will include only the value of the pledge and a generic description of the components of the pledge; that is, the pledge agreement will not identify each individual mortgage (or other financial asset) that makes up the pool of pledged assets. Due to borrower default or borrower prepayment, individual mortgages in the mortgage pool will from time to time change. For the purposes of the pledge, all mortgages will be considered interchangeable with all other mortgages as long as all have certain defined characteristics, like a maximum LTV or a minimum interest rate.

After lengthy discussions, Ms. Mokan agreed that the legal constructs were fully supported by Moldovan law. The bondholder representative can sign the Pledge Agreement on behalf of bondholders, and the master pledge can be registered in the Pledge Registry of Moveable Property. Notaries in the country have been duly instructed on procedure.

ATCI then assisted MAIB in instructing its auditors on the conduct of an agreed-upon procedure to monitor the mortgage pool. Auditors play a very specific role in covered bond issuance. The audit company chosen was Ernst & Young. ATCI presented and discussed with Ernst & Young and MAIB the role of an audit company in the pilot Project and the design of the Agreed-Upon Procedure. The audit company was very interested in this cooperation and in the development of new products and services. Under the terms of the contract between the issuer and the auditor, the latter will periodically perform an Agreed-Upon Procedure as follows:

- Choose a random sample of mortgage pool;
- Compare data in the loan dossier of the sample with data from the corresponding contracts in the Mortgage Cover Register maintained by the Bank;
- Verify the calculations of the main characteristics (weighted average of annual percentage rate on loan, weighted average of initial LTV, total outstanding balance, weighted average of outstanding term to maturity, and percentage of residential loans);
- Confirm the accuracy of the register and calculations.

The Bondholder Representative, as discussed above, is actually the trustee of a covered bond, acting in the interest of the bondholders by overseeing the process of mortgage pool monitoring and intervening on behalf of the bondholders to remedy technical defaults. In the case of payment default or bankruptcy of the issuer, the bondholder representative should be in a position to quickly place the mortgage pool with a backup servicer or sell it to another bank.

Ideally, the bondholder representative is another bank. Given the small size of the Moldovan banking sector, however, there is strong resistance to this idea. There is always resistance to the notion of another (competitor) bank having access to one's mortgage portfolio. The monitoring procedures are structured precisely so that the bondholder representative never has direct access to the issuer bank's mortgage portfolio data, but that in itself is not enough to convince MAIB to allow another Moldovan bank to serve as its bondholder representative.

The bondholder representative does not have to be a bank. German *Pfandbriefe* do not require that the bondholder representative be a bank, and often it is not even a legal entity. Among the possibilities are an unaffiliated asset management company and a legal firm. At the end of the project, MAIB had not yet chosen an entity to act as bondholder representative for any future covered bond issue.

In addition to structuring the issue and assisting the bank with the choice of auditor and bondholder representative, the Project also drafted two documents of critical importance to the issue: (1) the tripartite agreement governing the relationships among the issuer, the bondholder representative, and the auditor; and (2) a sample prospectus or investment memorandum, which the issuer is obliged to publish and disseminate among potential buyers before issuance. Last, ATCI also drafted new bond regulation for the National Commission for Financial Markets, which is discussed below in the Fixed Income section.

A step-by-step guide for financial institutions to follow in preparing for a covered bond issuance was completed during the last month (February 2009) of the Project's activities, and will be distributed (in Romanian) to all relevant financial institutions issuing mortgages, regulators, ministries and the NBU. This "road map" is presented in English as **Attachment 7,** "Guide to Preparing for Issuance of Covered Bonds in Moldova".

THE COVERED BOND CONFERENCE

MORTGAGE CREDIT FOUNDATION

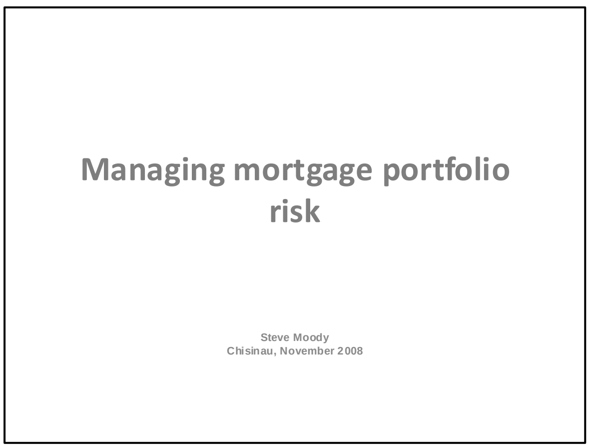
In June 2008, ATCI'S Country Director accompanied members of the Moldovan and Ukrainian covered bond community to the **12th Annual Central European Covered Bond Conference** (see logo to left) in Warsaw, sponsored by the European Mortgage Credit Foundation and the Association of German Pfandbriefe Banks. Attending from Moldova was Vitalyi Lungu, Head of the Investment Department at Moldova AgroindBank (picture below).

Perhaps the most instructive aspect of the conference for the Moldovan and Ukrainian guests was learning how well developed and diversified the covered bond market is. More than 130 covered bond professionals—traders, attorneys, rating agency specialists, regulators—from some 30 countries attended the two-day affair.

Vitalyi Lungu, right, in Warsaw.

RISK MANAGEMENT FOR MORTGAGE PORTFOLIOS

In the past quarter, ATCI conducted a seminar entitled "Managing Mortgage Portfolio Risk" for banks, mortgage companies and regulators. The seminar focused on the non-underwriting risks of mortgage portfolios—interest rate risk, maturity mismatch, currency risk and real estate market risk. ATCI prescribed a periodic, systematic analysis of the mortgage portfolio, using an Excel template developed by ATCI over the past two years in Ukraine and Moldova and beta tested during the past year by Prime Capital Mortgage Company in Chisinau.



A key feature of the template is a routine that calculates Average Monthly Prepayment at the portfolio level. The template also calculates Macaulay Duration both with and without prepayment for both straight-line and annuity type mortgage payment plans.

There were twenty-two participants at the seminar, including two representatives from the National Bank of Moldova. The presentation appears as **Attachment 8**, "Presentation, Managing Mortgage Portfolio Risk", and the Excel Template as **Attachment 9**, "Excel Mortgage Portfolio Risk Management Template".

Risk Management for Mortgage Portfolios: Excel Template

The Excel template that ATCI developed to calculate Average Monthly Prepayment and duration with prepayment is not bank- or software-specific; that is, it was not developed exclusively for Agroindbank or, say, Oracle bank software. It can be used as a risk management tool by any bank or mortgage company running standard bank software with an Excel interface. In response to a request for technical assistance on risk management from **Prime Capital,** a private mortgage company in Chisinau, ATCI recommended the company use the template to track the key indicators of its mortgage portfolio. Prime Capital has since incorporated the template into its regular risk management regime, even though the company has no interest at this point in issuing a mortgage covered bond. This is a case of secondary mortgage market development strengthening primary market practice and a step in the direction of greater standardization of recordkeeping and reporting on mortgage portfolios.

FINANCIAL LEASING

The objective of the Financial Leasing Component was to create a supportive environment for modern financial leasing. This was achieved by building the capacity of leasing companies through (1) training and consulting for potential lessees, farmers, regulators, and other interested parties, such as vendors, banks; (2) consultations with potential foreign investors in the sector; and (3) public awareness efforts. A Certified Leasing Specialist (CLS) Program was adapted to the Moldovan environment, in particular to areas related to taxation, legislation, and accounting; and presented to leasing professionals and potential leasing professionals, and to training providers for their subsequent delivery in Moldova. The program helped the market participants to attain world best standards of practice.

ATCI/Moldova also assisted in the development of the proper legislative and regulatory framework to support the leasing industry and facilitate the entry of foreign capital into the leasing sector.

CERTIFIED LEASE SPECIALIST PROGRAM

Initially, the focus of the Leasing Component was on establishing the CLS Program, based on a training program known as *Body of Knowledge*, which was originally established by? the Certified Lease Professional Foundation in the United States. The ATCI/Ukraine project first modified the training program in 2005 to fit Ukraine's environment. From that training program and course materials, ATCI/Moldova adapted the course materials to Moldova, modifying approximately 60-70 percent of the Ukrainian course materials. The CLS course in Moldova covers 3 full training days, with exams presented after each day. A CLS certificate is given to each trainee who successfully completes the 3 exams. Initially, the certificates were signed by the President of the CLPF in the US, a top USAID/Moldova official, and the Country Director of ATCI/Moldova. (Note: details covering the course materials and training are contained in the Project's quarterly reports.)

During the first (partial) quarter of ATCI/Moldova, the Project's Financial Leasing Advisor assessed the financial leasing activity in Moldova. A short-term expert from the ATCI/Ukraine project visited Moldova in order to become familiar with the activities as well as the major players conducting financial leasing activities to further assess Moldova's leasing environment. During the visit, meetings were held with eight (8) leasing companies, an equipment vendor, and an insurance company. The purpose of these meetings was to develop a Certified Lease Specialists training program in Moldova by adapting training courses from other countries, as well as to focus on the specific needs of the leasing market in Moldova. Brief highlights of the information gathered include:

- Most leasing activity in Moldova is centered on the leasing of private vehicles;
- Approximately 80-90 percent of the total leasing activity is handled by the 3 top leasing companies;
- Total leasing activity in Moldova is estimated at USD42 million;
- Leasing companies need capital to finance their activities; and
- Training is highly desired by all leasing (and potential leasing) professionals, particularly in the areas of marketing, credit and risk management.

One of ATCI/Moldova's primary objectives in establishing the CLS program was to build the capacity of local trainers, who would then be able to provide commercial training for lessors and industry professionals, both within and outside the program. The local ATCI/Moldova Financial Leasing Advisor had identified several potential Leasing Training Providers and contacted them to ascertain their interest in becoming CLS training providers for Moldova. Potential providers were invited to attend the initial CLS Program, which was held in Moldova during the early part of ATCI's third quarter, April-June 2007.

During the second quarter (January-March 2007):

- The Leasing advisor and attorney from ATCI/Ukraine visited Moldova to meet with leasing professionals in Moldova to carry out their own assessment of the leasing environment in Moldova. Their goals were to (1) assess the needs in adapting the CLS program to Moldova; (2) meet with prospective Training Providers; (3) determine the interest of the leasing companies in establishing a Lease Association in Moldova; and (4) assess the legal environment for leasing in Moldova. Meanwhile, the ATCI/Moldova team identified specific needs and started adapting the CLS course materials to Moldovan standards, practices, and the overall environment.

- To determine the impact of the Project's activities, leasing companies were surveyed about their activities as of the end of 2006. Although not all leasing companies returned the survey, the 6 companies that did represented approximately 85-90 percent of the leasing industry. The goal was to gather statistics on current practices (as of end 2006) and market shares in order to set benchmarks for future reviews of the Project's impact on the Leasing Industry in Moldova.
- The Project sponsored the Lease Advisor and representatives of 5 top leasing companies to attend the annual LeaseEurope conference in Kiev, where relationships with other European lease companies and suppliers were established.
- A tender for selecting the Training Provider for CLS courses was conducted, and a local company, Accounting and Auditing Professionals (ACAP), was selected.

In the third quarter of ATCI/Moldova (April-June 2007), the adaptation of the CLS program for Moldova was completed. Much effort went into adapting the courses for the Moldovan environment, particularly in the areas of accounting, legislation, taxation, and documentation. Adaptation of training materials had begun in the previous? quarter; Project staff members, the Leasing Advisor along with the Legal Team, ACAP, and experts from the ATCI/Ukraine project all assisted in adapting of the materials. Courses 1 and 2 were also delivered during the third quarter. Both courses were presented in the Project's Training Center, with 23-25 trainees representing 8 leasing companies and other institutions. (The 3rd and final CLS course was delayed until the end of the fourth quarter due to vacations of the trainers and the trainees during the summer.) Trainers for these courses included ATCI/Ukraine's Leasing Expert, trainers for the Training Provider, and the senior Legal Advisor of ATCI/Moldova. (Note: see the CLS training reports for more details regarding content material and specific trainers for each course.) When asked to make some comments about the CLS training course, 6 trainees provided comments of appreciation to USAID/ATCI. (Note: see report attached to quarterly report for specific commentary of the trainees.)

The initial CLS program was completed in ATCI's fourth quarter (July-September 2007) with the presentation of the 3rd CLS training module. A total of 18 trainees representing 7 leasing and other companies passed all three exams and became Certified Lease Specialists. Certificates were awarded to these graduates in a future quarter (the 7th quarter) as they had to be signed by the CLP Foundation president in the United States, although at the end of the third module, a "graduation" ceremony took place, with the ATCI Country Director handing out mini-accreditation acknowledgements. At the ceremony, the Country Director reminded the graduates of the need for them to create a both a Leasing Association (made up of leasing companies) and a Leasing NGO (made up of CLS certificate holders), the latter to be responsible for the CLS exam content, administration, monitoring, and grading of the exams.

This fourth quarter focused on completing the initial CLS Certification Program. Much effort went into adapting the courses for the Moldovan environment, particularly in the areas of accounting, legislation, and leasing documentation, to make them as practical as possible. The exams, likewise, were adapted to the CLS course materials presented in Moldova. Exams questions were taken from the CLS course in Ukraine, where relevant, and otherwise adapted or developed by the ATCI Leasing Advisors in Moldova and Ukraine, as well as by the Trainers themselves.

A protocol between ATCI/Ukraine (the "mother" ATCI project) and the CLP Foundation in the US was eventually signed to allow ATCI/Moldova to use the CLS logo, name, etc., and to issue certificates on behalf of the CLP Foundation. The CLP Foundation charged a one-time licensing fee to the ATCI/Ukraine project in this regard.

The sixth quarter of ATCI/Moldova saw the launching of the second CLS program, with the first and second modules of the CLS course being presented by the Training Provider and ATCI lease advisors. Where needed due to changes in legislation, taxation, and accounting rules, the materials were updated and modified by the Training Provider.

During the seventh quarter (April-June 2008), ATCI/Moldova organized the third module of the CLS course and 2-day examination session, thus completing the second full CLS Training Program. On June 11, 2008, the 27 leasing specialists that graduated from the first and second CLS programs—representing 9 local leasing companies as well as banks, insurance companies and consulting firms—received certificates issued by the CLP Foundation and Regional USAID Mission to Ukraine, Moldova, and Belarus. (NOTE: see attachments of quarterly reports for details on these CLS courses.)

In the eighth quarter (July-September 2008), the CLS training courses were presented on a commercial basis by ACAP for the first time. It was the first local training course for the leasing industry that analyzed both the activities undertaken by leasing companies and the outside factors that could have an impact on the companies.

Establishing an efficient leasing sector based on world best practices is one of the major objectives of Moldova's financial community. The facilitation of access to financing through leasing will accelerate the renovation of equipment/machinery and transportation fleets in most sectors of the economy; and this, in turn, will contribute to enhancing enhance economic activity, generating new jobs, and improving living conditions in Moldova. These goals can only be achieved if the leasing industry has highly qualified personnel with a clear view of the market and full understanding of customers' needs.

Preparing these personnel (Certified Leasing Specialists and trainers) represents the contribution of the ATCI/Moldova Project to the establishment of qualitative international standards for financial professionals in the Republic of Moldova. Since the beginning of the Project, ATCI/Moldova has been looking for local partners which could take over the management and administration of the CLS program when the Project ends.

ATCI Moldova chose ACAP as Training Provider as well as Exam Controller. While selecting the partner for CLS, ATCI/Moldova took the following into account: the major contribution of the ACAP to the development of training and consultancy market of Moldova; qualifications and professionalism of persons proposed by ACAP as CLS trainers; as well as the contribution which CLS could add to the strengthening of the ACAP position within the financial community of Moldova.

ATCI/Moldova, together with ACAP, has developed a sustainable and effective plan for implementing the CLS program on a commercial basis. The plan is based on thorough budgeting and break-even analysis, and meets the market realities for a commercially-offered CLS program.

CLS PROGRAM 3, MODULE 1, COMMERCIAL BASIS

On September 26-28, 2008, ATCI/Moldova, together with ACAP, launched the third CLS course on a commercial basis. The participation fee was established at USD40 per module (USD120 per full course) per trainee. The break-even level was 17 participants; due to the fact that ATCI managed to form a group of 23 participants, representing 7 local financial institutions, ACAP covered additional administrative expenses and registered a profit. Thus ACAP has an incentive to continue running the program.

Throughout the first module, ACAP utilized local training exclusively, ATCI/Moldova staff and ACAP trainers, Thereby avoiding expenses related to foreign consultants' visits. The second and third modules of the CLS program were presented early in the next quarter, and certification exam sessions took place in mid-quarter.

Course structure:

The CLS courses followed the originally implemented training program, made up of three modules:

I. Leasing: business environment.
II. Leasing transactions: stages and procedures.
III. Leasing company: development strategy and operational activity.

For example, the first module consists of 12 sessions (80 minutes each). During these sessions, the following subjects were discussed:

1. Introduction to CLS Program. The appearance and early development of leasing. The modern history of leasing. The present situation and current global tendencies. The leasing sector in the Republic of Moldova.
2. The legislative framework of leasing in Moldova. Legal definitions, types and forms of leasing. Difficulties in applying the law. Inception questions.
3. The leasing contract., form, characteristics and clauses. Conclusion, registration and guarantee.
4. Modification and cease of the leasing contract. Claiming the assets financed in leasing. Disputes. Advanced norms of other countries.
5. General aspects of leasing operations' accounting in Moldova. The role of financial accounting in the financial and information systems of the economic entity. *Participants' questions.*
6. Basic normative acts regulating accounting of leasing operations. Main accounting entries on leasing operations. *Case studies.*
7. Basic notions of IAS 17 and GAAP 13. Comparative analysis of alternatives for obtaining fixed assets: procurement, lending and leasing.
8. Criteria of quantitative evaluation of leasing operations efficiency. Net present value method: general notions and approaches. Discounting techniques. Net present value rule. Important notes. *Case studies.*
9. Fiscal aspects of leasing transactions in Moldova. Fiscal legislation, income tax and other taxes. Calculation of depreciation for taxation purposes.
10. Deduction of expenses for property repairing. Income tax at the source of payment. Taxation of non-residents. Customs regulations. *Case studies*.
11. Basic notions on value-added tax (VAT) and specific VAT applications. VAT calculation and payment procedures. VAT-exempted supplies.
12. Tax liability terms. Paperwork on supply of goods representing leasing objects. *Case studies.*

To make the CLS course as practical as possible, the modules were adapted to the current Moldovan environment, and the ATCI/Moldova staff together with ACAP trainers developed several case studies that required participants' active involvement in performing specific calculations and analyses. See relevant attachments for more details regarding these courses.

In the Project's ninth quarter, the third complete CLS program produced an additional 12 graduates, for a total of 39 Certified Lease Specialists in Moldova during the Project's life.

ACAP, the Training Provider, has scheduled the next CLS program to begin in the spring of 2009; this CLS program will continue to be offered on a commercial basis.

LEASE SURVEY, RESULTS AND ANALYSIS, AS OF END 2007

On a periodic basis, ATCI/Moldova conducted leasing market surveys to assess the actual leasing situation in the leasing market, showing indicators as of the end of the each year. A comprehensive survey was conducted as of end 2007, showing results from the previous 6 months and 12 months, where available. See Romanian version cover to the left. The Project sent detailed questionnaires to the companies active in financial leasing operations, requesting completion of the survey based on their own activities and results for the year. Results were compiled and presented in a Leasing Benchmark presentation as well as a brochure, which was distributed to the leasing and financial companies, regulatory bodies, and to government ministries.

ATCI/Moldova completed the first ever official leasing market research in Moldova (period under analysis: 2006-2007) based on a direct survey. This market research is expected to give leasing company investors and managers a tool for self-assessment. The survey's aggregated results will also establish the essential benchmarks for the industry to monitor the evolution of the leasing market. The main objectives of the research were to:

- Identify the real situation in the leasing market and evaluate its dynamics.
- Promote market segmentation, while emphasizing the sectors with an accelerated pattern of growth.
- Calculate the main indicators in the industry.
- Determine the opportunities in the leasing market.
- Identify main obstacles to development of the leasing market in Moldova.

The detailed results of the survey, as well as the market analysis and the main performance indicators, were disclosed to the leasing companies that took part in the survey, during a presentation entitled *Leasing Sector in Moldova: BENCHMARKS*. This PowerPoint presentation is included in this report as **Attachment 10.** Although the Project planned to assess and distribute results of a semi-annual survey for mid-2008, sufficient and relevant information was not submitted by the leasing companies. The Project's end as of February 2009 precluded the 2008 year-end survey.

The presentation *Leasing Sector in Moldova: BENCHMARKS* included detailed information that was mainly addressed to the leasing companies which took part in the survey. ATCI also published a non-technical brief brochure on industry benchmarks in the Project's eighth quarter (July-September 2008). The brochure was aimed at other interested parties, including professional non-leasing organizations such as the Ministry of Economy and Trade, Ministry of Finance, the National Bank of Moldova, and the National Commission of the Financial Market. ATCI/Moldova published and distributed this brochure in the Project's 8th quarter

During the presentation to the leasing companies, the ATCI Country Director initiated discussions with the CEOs of the largest leasing operators about the need to create a national leasing association. Industry representatives agreed verbally to form the association, but a memorandum or letter of intention must be signed by the companies holding not less than 60 percent of the assets in the total portfolio of Moldova, as required by law.

A summary of key findings from the survey follows:

	Performance Indicators	**Unit of Measure**	***December 31, 2007***
1.	Total number of leasing operators active in Moldova	companies	*19*
2.	Total value of the leasing portfolio in Moldova	millions MDL	*914,6*
3.	Leasing portfolio structure	percent	• Automobiles – 78.6% • Commercial vehicles – 6.9% • Equipment – 11.7% • Real estate – 2.8%
4.	Percentage of repossession procedures initiated in leasing portfolio	percent	2.2%
5.	Percentage of defaulted contracts in leasing portfolio	percent	3.8%
6.	Weighted average structure of sources of finance for leasing transactions	percent	• Local banks – 59% • Self-financing – 24.7% • International Finance organizations – 8.8% • Foreign banks – 7.5%
7.	Total number of lessees in Moldova	lessees	3 268
8.	Structure of lessees	percent	• Individuals – 56.7% • Companies – 43.3%
9.	Average cost of the financed asset	MDL	272 429

10.	Average financed amount	MDL	246 275
11.	Leasing penetration rate	percent	8.2%
12.	Share of leasing operations in total fixed capital investments	percent	6.77%
13.	Share of leasing transactions in GDP	percent	1.9%

KEY ADVISORY ACTIVITIES, ROUND TABLES, AND RESULTS

GLOSSARY OF LEASING TERMS

In an attempt to harmonize the terms used by sector professionals who speak Russian and Romanian, and familiarize the non-professional interested parties with specific concepts used in this business, the ATCI/Moldova team, together with CLS trainers, developed a bilingual "Leasing Glossary" which contains more than 160 terms. The glossary was highly appreciated by the CLS participants and the leasing industry as a whole, and is considered to have established the basis for standardized professional terminology. (Note: the Leasing Glossary is found as an attachment to ATCI Moldova's 7th quarterly report.)

FLOATING CHARGE

Toward the end of the Project's first year and at the start of the second, ATCI/Moldova focused on problems confronting the leasing industry. To address the issue of **financing alternatives,** ATCI/Moldova organized and presented a Round Table for stakeholders relating to leasing and lease financing. In all, 23 people attended the Round Table, representing 7 lease companies, 11 commercial banks, 2 USAID-funded projects, and USAID. Following up on actions taken by ATCI/Moldova in the previous quarter, the Round Table discussed the issue of "floating charges"—or liens, in American terminology. Typically, in Moldova, a bank would finance a lease company's individual asset, e.g., a car or a piece of equipment, using that specific asset as collateral for financing. The floating charge concept, used in Europe and America as well as in other countries, provides for financing by a bank to a lease company, using as collateral the whole (or part) of a company's assets, or its receivables based on leases outstanding. "Floating" assets or receivables can be utilized within the business operations of a company, or can be replaced with other assets or receivables of like value, according to the decisions of the company. The financing remains unchanged as long as the value of the underlying portfolio of assets or receivables remains.

In applying the floating charge to financial assets, leases are financial "goods" (as are mortgages), and the aggregate value of a leasing portfolio may be pledged to secure a loan (or, in the case of mortgages, a "covered bond").

There are major advantages to leasing companies and banks using the floating charge. These include:

- Its *flexibility*, first of all for the debtor; though the creditor has more flexibility in terms of alienating the right to claim.
- The debtor is free to use its assets in an ordinary way for its business development, although the debtor's assets are encumbered based on the floating character of the pledge,
- It is not necessary each time to reach an agreement regarding use of the assets/portfolio for economic activity (the procedures of pledge registration and administration are simplified).

Although the Round Table focused on the use of a floating charge by a leasing company, virtually all types of companies may be able to be financed through the use of a floating charge. Companies, though, should understand that use of the floating charge assumes—from the point of view of eventual risks—the debtor's good business reputation of the existence of some long-term business relations between the creditor and debtor. The legal team of ATCI/Moldova concluded that under the current legislation, the pledge grants preference as to other creditors, including the state, the floating charge concept is to be preferably implemented in the conditions of the pledge contract and not other ordinary contracts (guarantee, retention, etc.). **Attachment 11**, *Floating Charge Presentation*, is attached as well as **Attachment 12**, *FAQ Brochure re: Floating Charge,* which presents the floating charge in an informational brochure that was disseminated to stakeholders and interested parties at the Round Table.

ATCI first introduced the concept of the floating charge in Moldova at a presentation in November 2007, (Project's 5th quarter) as mentioned above. During the following quarter, ATCI assisted USAID's Competitiveness Enhancement and Enterprise Development (CEED) project in structuring a bank loan for a leasing company client using the floating charge concept. ATCI and CEED assisted **IMC Leasing** and **MobiasBank S.A.** in drafting a floating charge agreement wherein current and future leasing company receivables serve as collateral for a loan. ATCI worked with MobiasBank and IMC Leasing to flesh out the agreement to the satisfaction of both the bank and the leasing company. The loan closed after the quarter ended; **it was the first use of floating charge by a Moldovan leasing company and bank.**

LEASING PROBLEMS AND SOLUTIONS

Taking on other current problems faced by the leasing companies, ATCI/Moldova held meetings with the leasing companies, Ministry of Economy, and other stakeholders to determine various solutions to those problems. Problems included:

- Application of VAT on services rendered by leasing companies
- Deductions by leasing companies on their taxable income
- Re-evaluation of claims n leasing contracts
- Establishing a blacklist for problem lessees.

Solutions to these problems were discussed, and presented in Attachment 13, Leasing Problems and Possible Solutions. This document was sent to the Ministry of Economy and Trade, which discussed solutions with other ministries and submitted legislative amendments to the Leasing Law.

LEASE ASSOCIATION AND LEASE NGO

The Project pledged to support the leasing companies in creating a Leasing Association and supporting the CLS graduates in forming a Leasing NGO, to no avail. The Lease Association would have been made up of leasing companies and would act mainly as an advocacy group. The Lease NGO would have been made up of CLS graduates, who would then take on the responsibility for CLS course presentations through a training provider (e.g., ACAP), and for preparing, administering, and grading the CLS exams. The plan was for ATCI/Moldova to support the NGO and the association financially during the initial stages, as well as provide legal technical assistance. To this end, discussions with leasing companies and leasing professionals who passed the CLS exams took place during the Project's first year (2006-07)

As the financial crises took hold in late 2007 and through 2008, however, interest in the plan faded. At the end of the Project, Moldova is left without either a Lease Association or a Lease NGO. Through ATCI/Moldova's efforts, it is hoped that the companies will eventually form an association to advocate for their interests. In the meantime, ACAP will continue to provide CLS training, will update and modify the CLS courses as needed, will update and replenish the question bank for the exams, and will coordinate with the exam-administrator CIPAEN or another qualified organization to administer the exams. The CLP Foundation in the US is in contact with ACAP to ensure that the CLS process continues. As of February 2009, ACAP has scheduled the next CLS course to be held in the spring of 2009.

OTHER RELEVANT LEASE-RELATED ACTIVITIES

In addition to the capacity building and consultancy work that ATCI/Moldova performed throughout the Project's life, with one-on-one consultations, Round Tables, and discussions leasing companies, the Project's Legal Team also drafted a guide for foreign leasing companies and investors entering the Moldovan market. The guide, which addresses tax, fiscal, and legal issues, and the required payments of various fees, helped facilitate the import of capital and know-how into the Moldovan marketplace. The brochure was distributed to leasing and financial companies as well as to government bodies, and was posted on the ATCI/Moldova website. See **Attachment 14**, *Legal Climate for Companies Coming into Moldova.*

In another leasing-related area, and overlapping with the bond issuance activities for the Project's fixed-income component, ATCI/Moldova assisted MAIB Leasing in the preparation of its proposed corporate bond issuance. The Financial Analyst on the team drafted and presented a Bond Model specifying the term, pricing, interest, and duration, based on historical and current environments. The new Chief Executive of MAIB Leasing met with the ATCI/Moldova Financial Analyst and with Steven Moody, ATCI/Moldova's short- term expert in Fixed Income (at the time, later to become ATCI/Moldova Country Director), to discuss problems with the company's filing for registration with the Securities Commission. Follow-up discussions continued to find a solution to the registration problem, as well as to make plans for the road show and issuance for the bond. But in the end, MAIB Leasing decided not issue due to changes in the company's top management and to the deteriorating financial environment.

FIXED INCOME

The objective of the Fixed Income Component was to expand the availability of capital to corporate borrowers, by (1) working with the National Commission for Financial Markets to ease the legislative and regulatory burden on bond issuance; and (2) helping potential issuers bring corporate bonds to the market. In the end, ATCI did deliver a full set of revised corporate bond regulations to NCFM but, although ATCI worked with several potential issuers, no corporate bonds were issued in Moldova during the project's two-and-a-half years of operations. By that measure, an accurate assessment is that the Fixed Income Component accomplished only 50 percent of its objective.

Project management has pointed out that turmoil in Moldovan credit markets beginning in the second quarter of 2008, and eruption of the global financial crisis in third quarter, effectively prevented corporate bond issuance during 2008. That is correct as far as it goes. But it masks more fundamental obstacles in the structure of the Moldovan economy and financial sector which may stand in the way of corporate issuance in Moldova for some time. There are four such obstacles.

First, the service sector accounted for more than 60 percent of Moldova's GDP in 2007 and 2008. The service sector is labor intensive, not capital intensive; it does not require periodic, long-term investment in plant and equipment. It is, therefore, an unlikely source of corporate bond issuance. Likewise, agriculture's financing needs are best met by short-term bank loans or, in the case of equipment replacement, by longer-term financial leasing contracts. In 2006 the wine industry had its product embargoed by Russia—until then its largest customer—and in 2007 the country suffered a devastating drought. In 2008, massive devaluations of the Ukrainian hrivnya and the Russian ruble brought border trade in agricultural products to a halt. Further, Moldovan apparel manufacture in the south operates largely on tolling arrangements with European name-brand labels. And the one sector which does from time to time requires long-term investment in expensive equipment—the telecom industry—is still state owned. In short, the structure of Moldova's economy does not itself encourage corporate bond issuance and, in the current political situation, that structure is not likely to change.

Second, Moldova's banking industry, while small and relatively unsophisticated, is growing much faster than the economy as a whole. Bank assets increased 45 percent in 2007 and 22 percent in 2008, compared to GDP growth of 3 percent and 7.2 percent, respectively. Rapid banking sector growth in 2007 was fueled by excess liquidity, which appeared as a result of (1) insufficient sterilization of foreign currency inflows by the National Bank, and (2) a small but extremely lucrative US dollar-based carry trade in the Moldovan lei, which attracted more MDL deposits than otherwise would have been the case. Astonishingly, even after the draconian measures taken by the National Bank in 2008, Moldovan banks are still carrying excess reserves—though much fewer than at the end of 2007—meaning, of course, they do not need the additional funding bond issuance offers. They do need to diversify out of deposits as virtually the sole source of funds, and given the dubious condition of their European partner banks caught up in the global financial crisis, they may need dollar- or euro-denominated funding in the near future. As a rule, however, banks with excess reserves do not issue bonds—mortgage bonds included.

Third, there are no institutional investors—investment funds, private pension funds—in Moldova. It is, of course, expensive, time-consuming and administratively burdensome to place a large issue with a multitude of individual small investors whose investment horizons, in any event, tend to be shorter rather than longer term. But the likelihood of private pension funds developing in Moldova in the short term is not good for two reasons: (1) deposits aside, there are no financial instruments in the country for them to invest in, and (2) there are actuarial problems with developing annuities for such small populations. The first issue is not just a chicken-and-egg problem; the fact is, for the immediate future, any funds accumulated in Moldova would have to be invested offshore—Europe, US, Russia—where they would automatically create currency mismatches for future pensioners, the risk of which should be outside the prudential norms of pension regulation. The second issue is technical in nature (i.e., retiring annual cohorts in Moldova can never constitute a statistically valid sample for the purposes of calculating annuitant mortality), and can probably be overcome by some enterprising actuarial modeling, but it remains a disincentive to market entry for life insurance companies, the usual issuers of annuities.

Last, the poor state of relevant law and regulation and the National Commission's lack of knowledge about bonds and bond markets is, if not an obstacle, at the very least a substantive hindrance to development of a corporate bond market in Moldova. The laws and regulations date from the mid-1990s, when the prevailing concern of lawmakers and regulators was preventing Ponzi schemes like the infamous MMM affair in Moscow. Thus, for example, the Civil Code requires that all transactions involving corporate bonds be conducted in cash, meaning specie, and Article 29 of the Joint Stock Companies Law limits corporate bond issuance by any one company to the amount of its paid-in capital. ATCI identified ten other oddities and antiquities in the Civil Code and laws related to bond issuance. Regulation, likewise, is cumbersome, convoluted, and confusing, written, it appears, to benefit the regulator willing to take a bribe rather than either issuers or bondholders. Under conditions such as these, perhaps the happier result for ATCI is that exogenous events intervened to prevent corporate bond issuance. Issuance notwithstanding, ATCI's contribution to the fixed income sector was significant.

CAPACITY BUILDING AT THE NATIONAL COMMISSION OF FINANCIAL MARKETS

A major activity within the Fixed Income Component was to build the capacity of the National Commission of Financial Markets (NCFM). The NCFM evolved from the National Securities Commission (NSC) in July 2007, when the Law on National Commission of Financial Markets became effective, making NCFM the mega-regulator—the regulator of non-banking financial products and institutions. Prior to this, the NSC supervised the securities market and its professional participants and products, and there were separate state regulatory bodies for insurance companies and products, and for pension funds and activities.

- To assist the NSC in its transformation into the NCFM, ATCI/Moldova brought in a short-term expert in the second quarter (January-March 2007) to work with the NSC and the other relevant regulators. This expert spent a good part of 3 weeks' work gathering information onsite; she held 20 meetings with NSC staff and with other regulators and participants of the capital and financial markets. Her work culminated with a 50-page report, *Report on Mega Regulator Development,* found in ATCI Moldova's 2nd quarterly report), which had been delivered to the NSC in English and in Romanian. The report's recommendations were presented in the form of a time-bound action plan and were discussed with NSC.

Other activities during the second quarter relating to the implementation of regulatory reform and assistance to the NCFM included:

- Review of existing legislation by the ATCI/Moldova Legal team and other key staff members, with recommended provisions drafted to fill gaps in laws regarding the issuance of bonds and increased capacity. The Legal Team conducted initial analyses and reviews of these laws, and recommended provisions needed to ease bond issuance and increase the capability of the Mega Regulator to carry out its responsibilities according to international best practices.
- Recommendations made to the NSC in its application to IOSCO for membership. The application for membership was made and will be discussed at IOSCO's General Meeting in the spring of 2008.
- Initial analysis of financial statements of potential corporate bond issuers. The Project selected top companies for potential bond issuance and started analysis of financial statements of these companies. With confirmation that a company was a good candidate and had the desire for bond issuance, based on its recent track record and its creditworthiness, follow-up meetings were held to prepare for the bond issuance.
- Agreement by ATCI/Moldova to sponsor a delegate from the NSC to attend the US Securities and Exchange Commission's 2-week Annual International Institute for Securities Market Development program in Washington, DC, which was held in April 2007. The NSC selected the Head of the Market Operations Department to attend the SEC's Institute. The Country Director drafted an agreement on actions necessary for the delegate as well as the NSC to comply with, including attending all sessions during the 2-week period in Washington, DC;

making all materials available to all colleagues at the NSC; and submitting a report, verbal and written, to the NSC staff and to the Project's Country Director on the information gained while attending the SEC's Institute. The report was delivered during the subsequent quarter.

ATCI/Moldova's assistance to the National Securities Commission in development as the Mega Regulator for Non-Bank Financial Institutions was continued in the third quarter (April-June 2007) through various activities, which included:

- The Project discussed with and delivered a set of proposals to NSC officials with regard to amendments to the Securities Market Law, especially provisions related to bond issuance and regulation. Further analysis took place during the subsequent quarter, when the Project planned to have relevant legislation and the implementing regulations reviewed by a short-term expert (a Capital Markets attorney who is a specialist in bond activities), as well as by the Project's fixed-income expert, to determine the legislative needs of the Mega Regulator
- The Project analyzed a set of laws and European EU directives, and made recommendations for amendments to the Law on Securities Markets. Incorporated in these recommendations were analyses of Romanian, Ukrainian, Russian and Kazakh laws and regulations.

During the fourth quarter (July-September 2007), ATCI/Moldova continued its assistance to the newly transformed National Commission of Financial Markets which included:

- ATCI/Moldova brought in an international Capital Markets Attorney as a short-term expert to meet with the NCFM and provide comprehensive review of the draft and current legislation and regulations, focusing on those provisions to ease bond issuance and regulatory restrictions, to ensure they were consistent with the EU Directives and international best practices. The Project's expert delivered a report of his findings and recommendations, as well as providing background on practices in EU countries. The expert concluded that the prior recommendations made by ATCI/Moldova to the NCFM for provisions to be added or amended were within EU guidelines, and that they would be sufficient to ease bond issuance. The report highlighted certain provisions, including the shortening of the time from 30 to 15 days, for NCFM to review documents submitted for registration for issuance of bonds. This report is found in the Project's 4th quarterly report.
- The Country Director of ATCI/Moldova delivered to the NCFM international best practices regarding the regulation of Credit Ratings Agencies (CRAs) and Investment Advisors. It is noted that there are no licensed CRAs or Investment Advisors in Moldova.

During the Project's fifth quarter (October-December 2007), based on the assessment and findings of the short-term expert, along with the findings of the Project's full-time staff, ATCI/Moldova made four key recommendations for the Draft Law on the Amendments to the Securities Market Law. These recommendations, designed to protect investors, were delivered directly to Parliament via the office of the United States Ambassador. The Ambassador understood that ATCI/Moldova was going to make these recommendations directly to the Chairman of Parliament, and decided to step in on the Project's behalf to draft a cover letter along with the attached recommendations, sending them directly to Chairman Lupu of Parliament. Recommendations included:

1. Adding a description of management bodies and an organizational chart to information disclosed for registration/in prospectus (note: adopted by Parliament);
2. Adding that submission of documents shall include financial reports with all corresponding annexes for the last three finalized financial years or for each concluded financial year since the date of issuer's constitution, if the respective period is less that three years (note: adopted by Parliament);
3. Shortening the review period from 30 to 15 calendar days from submission for the NCFM of registration documents for fixed-income securities (note: rejected by Parliament); and
4. Deleting the cap on bond issuance relating to the capital of a company (note: this amendment would affect the newly adopted Joint Stock Company Law; but as a new law, it was not able to be amended until in force for 180 days. Therefore, this amendment was not adopted).

Regarding rejection of the third recommendation, The Country Director suggested to the NCFM Commissioners at a subsequent meeting that the NCFM could accept a shorter review period if they had the will to do so. He pointed out that the shorter time period would lessen the market risk for the issuer. The NCFM stated that they would voluntarily comply with a shortened review period.

Later in the Project's second year, in providing assistance to the NCFM to build its capacity:

- ATCI/Moldova met with NCFM officials on several occasions to discuss the sections of the new Regulation on registration and issuance of corporate bonds that ATCI had drafted.
- ATCI/Moldova organized a meeting with Minister of Justice officials to explain the mechanics of covered bonds and discuss the possibility of registration of mortgage cover in the State Registry of movable property.

ATCI/Moldova drafted eight paragraphs of the Regulation on issuance and circulation of bonds. All the paragraphs were submitted to the NCFM and discussed.

Before the end of the Project, the Project delivered to the NCFM a completely drafted Bond Regulation which had been thoroughly discussed with the NCFM's key staff and Commissioners. ATCI/Moldova hopes that the NCFM will take steps to adopt this important Regulation without delay. A separate section on the Corporate Bond Regulation follows later in this section.

FIRST INTERNATIONAL BOND CONFERENCE, CHISINAU, MOLDOVA

ATCI/Moldova organized, sponsored, and presented the Moldova's First International Bond Conference in Chisinau, "Building a Bond Market in Moldova: Essential Steps for Development," in the Project's fifth quarter, on December 6, 2007. The National Commission of Financial Markets, the Ministry of Economy and Trade, and USAID were co-organizers of the conference. Welcoming remarks were made by Gary Linden, USAID; Viorel Melnic, Vice-Minister, Ministry of Economy and Trade; and Mihail Cibotaru, Chairman of NCFM. Keynote speeches were made by Victor Cibotaru, First Deputy Governor of the National Bank of Moldova and David Lucterhand, Chief of Party for ATCI. The conference chairman was Alexandru Savva, Advisor to the Chairman of the National Commission Financial Markets.

The main goals of the day-long conference were to demonstrate how bond issuance has been used by corporations globally as an alternative to bank financing, and how Moldovan enterprises could use a corporate bond market to access capital. The conference explored the theoretical and practical aspects of corporate bond issuance, including the economic basis for bonds, the necessary legal framework, methods and costs of issuance, and means of minimizing risk of default. In all, there were 16 presentations by participants from 7 countries (the United States, UK, Italy, Moldova, Romania, Georgia, and Bulgaria), focusing on best practices and country experiences for the 7 countries as well as for Kazakhstan. Among the hand-outs at this Conference was included the ATCI Moldova "FAQ Brochure on Fixed Income" (See **Attachment 15**).

Total attendance was 144 people, representing Moldovan Ministries, Parliament, International Donor Organizations, NCFM, Commercial Banks, Insurance Companies, Financial/Investment Companies, Industrial/Manufacturing Companies, Consulting Companies, and the Moldova Stock Exchange. Broadly, the topics of the Conference included:

- Overview of the Bond Market
- Structuring and Selling the Issue
- Importance of Credit Ratings for Issuers and Disclosures for Investors
- Bonds from the Investor's Perspective
- Legal and Regulatory Considerations
- Considerations for Domestic Issuance in Moldova
- Case Studies (3)

Formal presentations were followed by Panel Discussions, Questions and Answers from the Floor, Summary and Conclusions, and Next Steps for Moldova. See **Attachment 16**, "Agenda for Bond

Conference" and **Attachment 17**, "A Letter of Appreciation to ATCI/Moldova from NCFM Chairman Cibotaru".

These Next Steps, as well as concerns of the participants, included the need to:

- Ensure that legislative and regulatory framework is favorable for the issuance of corporate bonds, following best international practices;
    - Note that ATCI subsequently drafted and submitted a Bond Regulation for the NCFM, as well as amendments to the Securities Market Law in order to move Moldova toward international best practices in this area.
- Quick review turnaround time at NCFM for submission of documents;
    - Note that ATCI previously encouraged the NCFM to cut its review period from a maximum of 30 days to 15 days.
- Allow companies to issue bonds without restrictions related to their capital;
    - Note that ATCI had previously drafted and submitted amendments to legislation that would allow companies to issue debt without limitations relating to its capital.
- Develop a long-term Government Bond Curve, e.g., 6 month paper, 1 year, 3 year, 5 year, and 7 year. Anything longer than 7 years would be welcome, but this is a minimum for development of the yield curve
    - Note that this has yet to occur.
- Reduce deposit rates at banks;
    - Note that bank deposit rates still continue to remain high at the urging from the NBM.
- Conduct public relations/education for and about companies, the public and the media, regarding the development of bonds;
    - Note that this has yet to occur.
- Develop the demand side for corporate bonds; i.e., institutional investors, including Private Pension Funds; Insurance Companies; and Mutual Funds.
    - Note that this has yet to occur.

ATCI distributed a survey questionnaire to the remaining 100 participants during the last 3 hours of the conference; there were 39 complete responses, including 14 from companies that were potential issuers. Four of these companies stated that within the next year, they intend to issue bonds; eight companies stated that they would issue bonds within one to three years; and two insurance companies stated that they would issue bonds sometime after 3 years. Eight of these companies stated that they would like assistance from ATCI; while six indicated that they would issue the bonds without ATCI assistance.

The survey responses also included:

- General impressions of the conference's presentations as to complexity and Level of Information: 95 percent good to very good; 5 percent satisfactory.

  Positive comments included:
    - "A major foundation for the formation of strategy with respect to the role and use of bonds in the financial market."
    - "The examples and presentations of the development of this sector from neighboring countries, as well as the international best practices, are very appropriate for Moldova."
    - "Participation of the experts and professionals from different countries will encourage the development of the capital market and attract investments to the economy of the Republic of Moldova."
    - "The agenda was very well structured."

  Negative comments included:
    - "Better to conduct the conference over 2 days."
    - "Too many topics covered in too short a period of time."
    - "It would have been opportune to invite the representatives of municipalities" (NOTE: development of the municipal bond market was outside the scope of ATCI/Moldova's Work Plan.)

- As to *perceived* barriers impeding the development of the bond market in Moldova: 38 percent did not perceive barriers; 62 percent did perceive barriers. Comments relating to *perceived* barriers (legislative, economic, etc.) included:
    i. The interests of bondholders are not sufficiently protected.
    ii. High costs.
    iii. There is no government bond market for bonds with maturities of 5-10 years.
    iv. Corporate culture and joint stock companies' managers do not have sufficient understanding for taking decisions on bond issuance.
    v. Regulatory authorities tend to over-regulate the securities market.

Analysis of financial statements of and meetings with potential corporate bond issuers continued throughout the following year of 2008. It should be noted that although ATCI followed up with the companies that voiced interest in issuing bonds in the near term, no company issued bonds, due to factors that included lack of capability/creditworthiness, competing bank loan rates, and the onset of the global financial crisis.

CORPORATE BOND REGULATION

During the last quarter of the Project, ATCI completed the drafting of regulations on the issuance, circulation and redemption of corporate bonds, in accordance with procedures established by the Securities Market Law. See **Attachment 18**, "Work Plan for Bond Regulation Development".

The draft consists of ten sections, each addressing a distinct procedure, calculation, or rule governing the various stages of bond placement, payment of periodic interest, or retirement of the debt. In all, there are 35 paragraphs of regulation and four annexes containing sample forms, prospectuses, and reports. Definitions and procedures draw heavily on regulation and practice in economies with active bond markets, including Romania, Kazakhstan and Bulgaria. Unfortunately, the draft was completed in the absence of a functioning bond market and without benefit of a pilot corporate issue to test the relevance and adequacy of the new regulation and the National Commission's application of it.

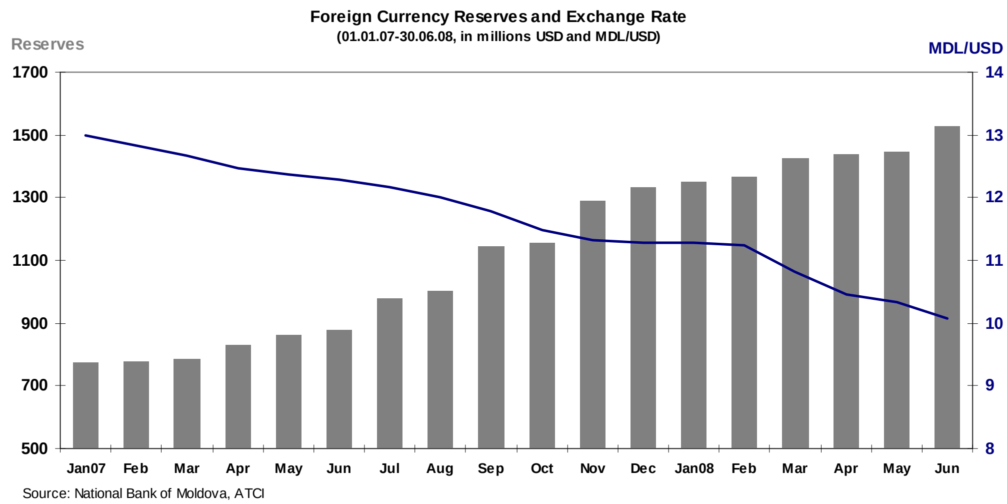
The regulation introduces **asset-backed securities**—an innovation for Moldova—and defines a new market participant, the **bondholder representative**, whose specific functions and responsibilities are detailed in the draft.

ATCI also identified 12 articles of law, including the Civil Code, which will require modification or elimination to ensure smooth functioning of a corporate bond market in Moldova. See **Attachment 19**, "List of Statutes for Modification for Bond Regulation."

Acknowledging ATCI's efforts in drafting the new regulation, the Chairman of the National Commission of Financial Markets presented ATCI's Country Director with a letter of appreciation.

GENERAL RESERVE FUND OF THE NATIONAL BANK OF MOLDOVA

In August 2008, ATCI met with the newly appointed Minister of Finance, Ms. Mariana Durlesteanu. The Minister raised the issue of losses in the National Bank, whose General Reserve Fund the Ministry of Finance might have to replenished as a result. The Minister asked for assistance from ATCI should the ministry have to issue bonds to replenish the Reserve Fund. ATCI therefore undertook a quick estimate of the devaluation losses on NBM foreign currency reserves, and estimated the status of the General Reserve Fund. See graph b below showing foreign currency reserves and MDL/USD exchange rates.



ATCI's analysis found that at end June 2008, NBM had accumulated MDL 1070.5 million (USD 107.0 million) of losses in its undistributed P/L account. According to the Project's estimates, the loss consisted of MDL 1519.44 million (USD 151.9 million) of devaluation losses on its foreign currency reserves, *less* MDL 443.34 million (USD 44.3 million) of profits from ordinary operations during the first half of the year. These are **estimates**. ATCI had access to the NBM balance sheet but not to its income statements, so the Project does not know the exact amounts in each component. The last balance sheet was published in June 2008.

At the end of the second quarter of 2008, NBM's balance sheet showed Statutory Capital of MDL 609.2 million (USD 60.9 million). Statutory Capital consists of 1/3 Authorized Capital (MDL 200.0) and 2/3 General Reserve Fund (MDL 409.2); thus:

Authorized Capital	200.0
General Reserve Fund	409.2
Other Reserves	13.6
Undistributed Profit (Loss)	(1070.5)

Assuming no further losses from MDL revaluation, undistributed losses at the end of December will decrease by the amount of undistributed profit from Ordinary Operations during the second half of the year. The Project estimates that this will be about MDL 450.0 million (USD 45.0 million), roughly equivalent to profit from Ordinary Operations during the first half of the year.

Authorized Capital	200.0
General Reserve Fund	409.2
Other Reserves	13.6
Undistributed Profit (Loss)	(620.5)

According to the Law "On the National Bank of Moldova," Article 19, Paragraph 5, the General Reserve Fund shall be used exclusively to cover registered losses at the end of the financial year. Thus, at end

December 2008, undistributed losses of approximately USD 62.0 million were to be transferred to the General Reserve Fund, where it will create a deficit of approximately USD 21.0 million. (MDL 620.5 - 409.2 = 211.3/10 = USD 21.13.)

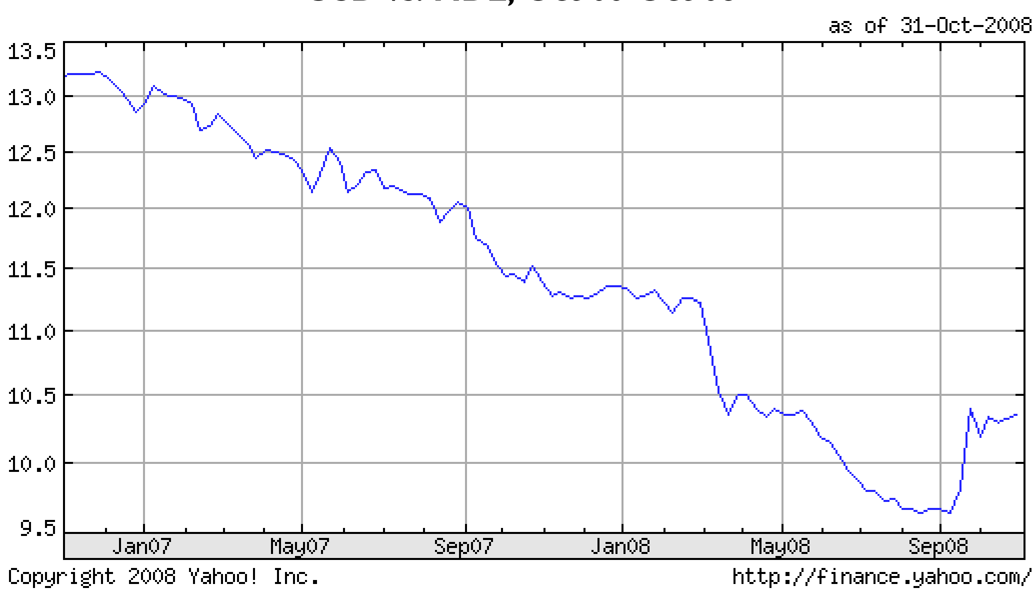
Authorized Capital	200.0
General Reserve Fund	(211.3)
Other Reserves	13.6
Undistributed Profit (Loss)	0.0

According to Article 19, Paragraph 6, the Ministry of Finance is required to cover debit balances in the General Reserve Fund within 60 days of receipt of NBM's audited financial statements. Thus, on or about 1 June 2009, the Ministry of Finance will have to issue government securities in the MDL equivalent of about USD 21.0 million and transfer those securities to the National Bank of Moldova. The securities do not go into circulation; they remain in the National Bank until maturity.

Given that the deficit in the General Reserve Fund will be relatively small, representing about 90 days of profit from ordinary operations of the bank, the Project would advise the Ministry to issue short-term bills (a maturity of six months or, maximum, one year).

See chart below reflecting the USD exchange rate vs. the MDL for the 2-year period from October 2006, the inception of ATCI Moldova.

USD vs. MDL, Oct 06-Oct 08



Obviously, other outcomes are possible. The extreme volatility of the foreign exchange markets during the past month takes the education out of educated guesses about the direction the USD/MDL exchange rate will take. Clearly, however, there was a sharp reversal of the two-year trend of a weakening dollar, so the "no additional losses" scenario may be the best guess. Smaller losses are, of course, possible, in which case the amount the Ministry of Finance transfers to NBM will less than USD 21.0 million and possibly even zero. The less likely possibility at this point appears to be the "additional losses" scenario, in which case the Ministry of Finance will have to transfer more than USD 21.0 million.

In any event, **it is the outstanding debit on 31 December 2008** that determines the amount of the transfer, if any. The transfer itself is probably a May-June 2009 event.

NBM's end-of-year balance sheet has not been published as of this writing. However, the third quarter balance sheet showed a MDL 207.9, reduction in undistributed losses, with *no additional foreign exchange losses on foreign currency reserves.* That suggests that quarterly profits from other operations in the bank were, in fact, about MDL 210, or about MDL 420 for the second half of the year compared to ATCI's estimate of MDL 443 for the same period. Thus, it appears ATCI's estimate of final losses in the General Reserve Fund will prove to be fairly accurate.

SEMINARS AND PRESENTATIONS

Between 1 February 2008 and 20 February 2009, ATCI Country Director Steve Moody made 16 presentations to various groups of financial sector professionals or students on various Project-related topics, of which 13 had to do with the sub-prime crisis, the US bailout, and the global financial crisis. See **Attachment 20**, "Sub-prime Crisis Power Point Presentation" and **Attachment 21**, "The Global Financial Crisis" (see picture below).

DEVELOPMENT CREDIT AUTHORITY MONITORING

The Development Credit Authority (DCA) was created by USAID to provide loan guarantees of up to 50 percent to financial institution partners that have been approved and accepted by USAID. The DCA project was originally part of the BIZPRO project in Moldova that ended in the fall of 2006, prior to the start date of the ATCI/Moldova Project. It was USAID's desire to continue monitoring activities of the financial institution partners regarding their loan activities, claims, reports, and verification of such claims and reports. Therefore, USAID/Moldova requested ATCI/Moldova to add this component to the Work Plan and add it to the Project's tasks and activities.

The DCA Component was added in late February 2007, during the Project's second quarter. When ATCI took over these monitoring activities, the DCA provided partial credit guarantees for six commercial banks and the Rural Finance Corporation. The DCA-related activities of the Project, which were ongoing throughout the remainder of the Project's life, included (1) monitoring how the financial institutions were utilizing the partial guarantees; (2) monitoring how these institutions were submitting claims; (3) assisting the financial institutions in completing surveys; (4) helping the financial institutions to prepare semi-annual reports for USAID; and (5) verifying the reports of the financial institutions that were submitted through the credit monitoring system.

It is noted here that activities within this Component were intended to be reactive, based on requests and inquiries made by the DCA partners, rather than proactive, with the Project taking steps to develop or strengthen the institutions.

By the end of the Project, only three bank partners had active contracts with the DCA: two banks had reached their maximum in guarantees; and one bank had a contract that was set to expire four months after the close of ATCI, and had no intention of utilizing the remaining balance in its DCA guarantee. Therefore, DCA cut its maximum guarantee to the existing level.

RESULTS/LESSONS LEARNED

TRAINING PROGRAMS

The Project successfully implemented (1) a Certified Mortgage Lenders (CML) Program, and (2) a Certified Leasing Specialists (CLS) Program. Expected results for CML were the delivery of three training programs throughout the life of ATCI/Moldova; *five* full programs were completed. Expected results for CLS were the delivery of three programs; three were delivered. Both programs have been handed off to the Training Providers, as they successfully completed 'train-the-trainers' programs. It is expected that with demand from the relevant professionals, these training programs will continue to meet that demand into the future, after the closing of ATCI/Moldova.

Overall results of these training programs have been to develop a well-trained cadre of mortgage and leasing industry professionals who use international best practices. The programs will continue on a commercial basis.

Lessons Learned: In developing economies, there is a great desire to learn best and international practices; in order to receive more developed education and skills, participants are willing to pay reasonable fees; training providers are willing to extend training on a commercially viable basis. During crisis situations, as developed throughout 2008 and beyond, demand declines as business slows, and therefore puts in jeopardy the presentation of training programs. It is important for the training providers not only to make a profit, in order to be sustainable, but also train the financial professionals before the crisis ends so that they will be able to meet increased demand for their services and for access to credit when the crisis wanes.

MORTGAGE LENDING INFRASTRUCTURE

All the infrastructure activities under the Mortgage Lending Component were tagged "as possible in Moldova" or "as appropriate in Moldova". These activities included:

- Developing mortgage-related life insurance;
- Developing the capacity of real estate appraisal and brokers' associations;
- Developing a mortgage-backed securities capability for the secondary market; and
- Facilitating the establishment of a credit bureau.

The ATCI/Moldova project was designed by USAID to mirror the design and piggy-back on the successes of the ATCI/Ukraine project. Yet USAID realized that the economy and markets in Moldova were not as developed as those in Ukraine and that planned activities might not be able to be successfully completed. That was the situation for all the infrastructure activities named above. ATCI/Moldova did successfully complete assessments for all activities, but the development of these activities did not come to full realization.

The evolutionary process of creating a legal basis for the development of industries and institutions in Moldova was ongoing throughout the life of the Project:

- During the latter part of the Project, the Insurance Law was adopted. It includes special restricting provisions for companies issuing life insurance policies; companies and policies need to be re-insured, and this has not been evident in Moldova;
- The Mortgage Law was submitted to Parliament just prior to the Project opening. The Project proposed some provisions to the Law, yet the Law was not adopted until the last few months of the Project, with some of the Project's proposed provisions adopted. However, the Mortgage Law was pertinent to only the primary mortgage

market without paving the way for the development of the secondary mortgage market, i.e., covered bonds; and

- The Credit Bureau Law sat in Parliament for more than a year, and again, was finally adopted and published during the Project's last few months. It will enter into force on March 1, 2009, the day after ATCI/Moldova closes. In the Project's Statement of Work, ATCI/Moldova was not to create a Credit Bureau until after a Credit Bureau Law acceptable to USAID was passed and signed into law.

ATCI/Moldova was successful in conducting assessments for the infrastructure activities named above, and also successful in preparing for activities after the relevant laws were passed, including preparing MAIB to issue a covered bond (see this section, above). However, due to time constraints after relevant laws were passed, and to low institutional capacity, the Project was not able to complete these activities. Thus, in keeping with the Work Plan's caveats, "as possible (or appropriate) in Moldova," ATCI/Moldova accomplished what was possible.

Lessons Learned: USAID had this foresight to tag the infrastructure activities as possible, at best. Nevertheless, the Project set the stage for any follow-on activities or projects in these areas.

Regarding mortgage-related life insurance, countries with small populations may have actuarial and/or demographics problems which slow the rate of financial sector development. In Moldova, for example, the size of the cohort of individuals reaching retirement age in a given year will not qualify as a valid statistical sample for purposes of calculating annuitant mortality tables. It is possible to get around the annuity problem by having pension funds make scheduled payments instead of a lump sum payment to purchase an annuity. However, the cohort size problem surfaces in different guises throughout the financial sector. It is part of the explanation for why some mortgage lenders cannot get the kind mortgage life insurance product they want: the cohort of mortgage borrowers is simply too small to attract the interest of life insurance companies.

BUILDING CAPACITY OF NATIONAL COMMISSION OF FINANCIAL MARKETS

ATCI/Moldova was quite active in building the capacity of the NCFM. Although the predecessor institution, the National Securities Commission, existed when the Project was initiated, the initial focus of the Project, at the request of the NSC, was to assist it in its transformation into the NCFM, the regulator for non-bank financial institutions, products, and activities. When the NCFM Law was adopted in July 2007, a totally new Commission, including the Chairman, was appointed. Four of the five new Commissioners were without any experience in the securities or financial markets, and without prior experience in regulation. The Project held periodic meetings with the NSC prior to and subsequent transformation; sent a staff person from the Commission to the U.S. SEC's annual emerging markets conference; brought in a short-term expert in development of a non-bank financial regulator; brought in another expert to review legislation and make recommendations for best practices in bond issuance and regulation; submitted amendments to laws and regulations moving toward best international practices in bond issuance and regulation; held bond conferences, round tables, and seminars; and held meetings with and submitted other regulations to relevant ministries in support of bond issuance. (Through ATCI/Moldova's efforts, the Ministry of Justice approved the legal structure of a covered bond.) These time-intensive activities were conducted on an ongoing basis.

Lesson Learned: In anticipation of the transformation from the National Securities Commission to the National Commission of Financial Markets, ATCI/Moldova never waivered in its support of the Commission. When new Commissioners were appointed, ATCI/Moldova provided extra support for building their capacity to understand regulations and perform as regulators. A project must be flexible in order to meet a changing environment or a changing of the guard(s). ATCI/Moldova remained flexible as well as productive in these efforts.

ASSISTANCE TO COMPANIES IN ISSUING BONDS

As stated in the body of this report, although ATCI did deliver a full set of revised corporate bond regulations to NCFM, and worked with several potential issuers of corporate and covered bonds (a covered bond is a corporate bond), no corporate bonds were issued in Moldova during the project's two-and-a-half years of operations. By that measure, an accurate assessment is that the Project accomplished only 50 percent of its objective in the Fixed Income Component. NCFM regulations were in place for issuance, but the Project needed to upgrade and revamp them for ease of issuance and regulation. What should be kept in mind is that some domestic issues factored into the lack of success in this area, or would have had a negative impact on post-issuance success:

- There are no institutional investors (not to mention a dearth of retail investors) in Moldova to absorb the securities once they are issued: no mutual funds, no pension funds, and few insurance companies to purchase securities;
- The remaining institutional investor, banks, had their liquidity dry up as the financial crisis evolved;
- The Stock Exchange is not dynamic, with low volumes of so-called trades, and historically only one issue traded (MAIB shares) on a semi-regular basis; and
- The financial and economical crises hit all potential issuers and all potential buyers in Moldova.

Lessons Learned: The events outlined above did not prevent ATCI's efforts to assist companies in issuing bonds. MAIB can now issue, when the timing is right. Other corporations have learned about alternatives in accessing credit; i.e., issuing a bond rather than obtaining a bank loan. Corporations large and small can and do issue debt securities, normally at lower prices than what would normally be available. ATCI/Moldova, did, however, in the face of a changing domestic and world market, change its emphasis from assisting companies in issuing bonds to making the legal and regulatory frameworks more acceptable for issuing companies. These efforts will serve to aid issuing companies in the future, when the international crisis is on the downturn and the domestic markets are on the upturn.

STATEMENT ON CLOSE OUT ACTIVITIES

ATCI/Moldova prepared for the closing of the Project by submitting a Demobilization Plan to USAID for approval. The Plan included activities for the phase-out of the staff, an inventory of and disposition plan for property, and the demobilization plan timeline.

The Project will close on February 27, 2009 (Friday), with all staff ending their work agreements, property picked up, and the office closed.

ATCI is an LOE-based contract; the LOE and monetary portion of the budget came in at or slightly below what was originally budgeted from October 2006 through September 2008, and then again after the extension of the Project from October 2008 through February 2009.